FLASH REPORT

ON KEY ECONOMIC AND FINANCIAL DEVELOPMENTS BASED ON THE JANUARY-JUNE 2005 DATA

Budapest, 14 July 2005

MAIN INDICATORS

	2002	2003	2004	2005
	fact		prel. fact	exp.
	volume change over the previous year,%			
Gross Domestic Product	3.5	2.9	4.2	3.5 – 4
Domestic use of G D P	5.5	5.7	2.2	2.5 – 3
of which:household consumption	9.4	7.2	2.5	3 – 3.5
gross fixed capital formation	9.3	2.5	7.9	5 – 7
Foreign trade turnover (goods and services)				
Export volume change	3.9	7.8	14.9	9 – 11
Import volume change	6.5	11.0	11.6	8 – 10
	change in percentage of previous year			
Gross average wages	18.3	12.0	8.2*	6 – 7
Net average wages	19.6	14.3	7.1*	8 – 9
Real wages, per employees	13.6	9.2	0.3*	4 – 5
Number of employees	0.1	1.3	-0.5	0 – 0.5
Unemployment rate (ILO), %	5.8	5.9	6.1	kb. 6.5
Consumer price index (annual average)	5.3	4.7	6.8	3.5 – 4
	at current prices			
Deficit of foreign trade balance, Euro billion	3.4	4.2	3.8	kb. 3.5
Current account deficit, Euro billion	4.9	6.4	7.1	7.2 – 7.5
Indicators in percentage of GDP	*in percentage of GDP*			
ESA95 general government deficit**	8.5	6.3	4.4	3.6
Current account deficit	7.2	8.8	8.8	8.3 – 8.8

*/ Adjusted for the change of the one month bonus payout in the public sector

**/ With the effect of pension reform

Introduction

In the past six months, the external economic environment was less favourable than originally projected. Recent surveys, however, indicate an economic recovery in the second half of the year, despite the prevailing risks, mostly related to the oil price trends, have increased. This outlook is supported by favourable profitability and financing conditions.

According to projections, economic growth in the EU will remain moderate for the entire year in 2005, and the growth rate may go even below the 2004 level. As the past quarter’s data also indicated, the growth of the Hungarian economy is driven primarily by the import demand of our main trading partners rather than their headline economic growth. Since April 2005 exports driven by increased Hungarian supplier activity to German export manufacturers have been expanding with the picking up of German exports.

In order to improve the budget balance, the Government adopted adjustment measures. However, they will mostly take effect in the second half of the year. Accordingly, despite the rapid increase in the fist half of the year, the general government deficit is expected to be 3.6% of GDP by year-end, in line with the original forecasts.

As a result of the fiscal adjustments implemented in 2002-2004, monetary conditions eased gradually. In the first half of 2005 the Monetary Council cut the base rate several times. Nevertheless, Hungarian interest rates are still high, central bank rates being considerably lower in all neighbouring countries. (Hungary 7 %, Czech Republic 1.75 %, Slovakia 3 %, Poland 5 %). After an improvement in international investment climate by June, the accelerating capital influx brought the forint to the level prevailing in the last 12 months. The appreciating real exchange rate and comparatively high real interest rates keep monetary conditions tighter than neutral. The disinflation starting at end-2004 continued vigorously in early 2005, may lead to looser monetary conditions.

The trade deficit was lower than one year before, indicating substantive structural improvements. The increase in income transfers is mainly due to dividend payments related to an FDI stock reaching almost 60% of GDP. As the balance of the capital account improved, the financing requirement as a percentage of GDP declined significantly.

Against this background, growth continues to be relatively high, though slightly lower than last year. In the first quarter, the GDP growth rate was 2.9% - or 3.5 % adjusted for calendar effects arising from the leap-day in the base period–, which is more than three times the Euro area average.

The demand side structure of GDP has been favourable. Underlying the decelerating economic growth, attributable mostly to the effect of the leap-day, there is a dynamic investment activity, growing export performance and moderate consumption growth.

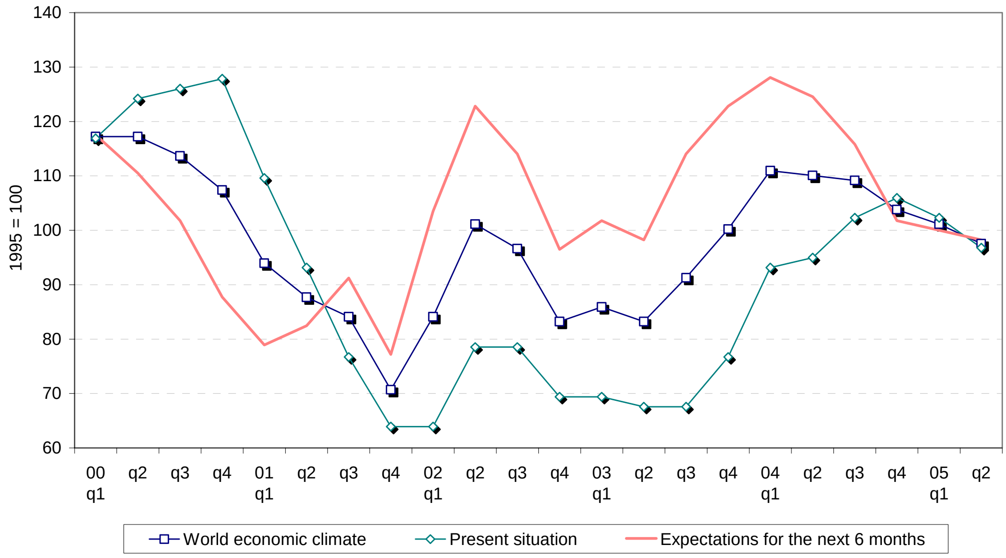
Based on the above, the GDP growth for the entire year is likely to be around the low edge of the projected 3.5-4% range, accompanied by improving equilibrium indicators and inflation not exceeding 4%.

1. External economic environment

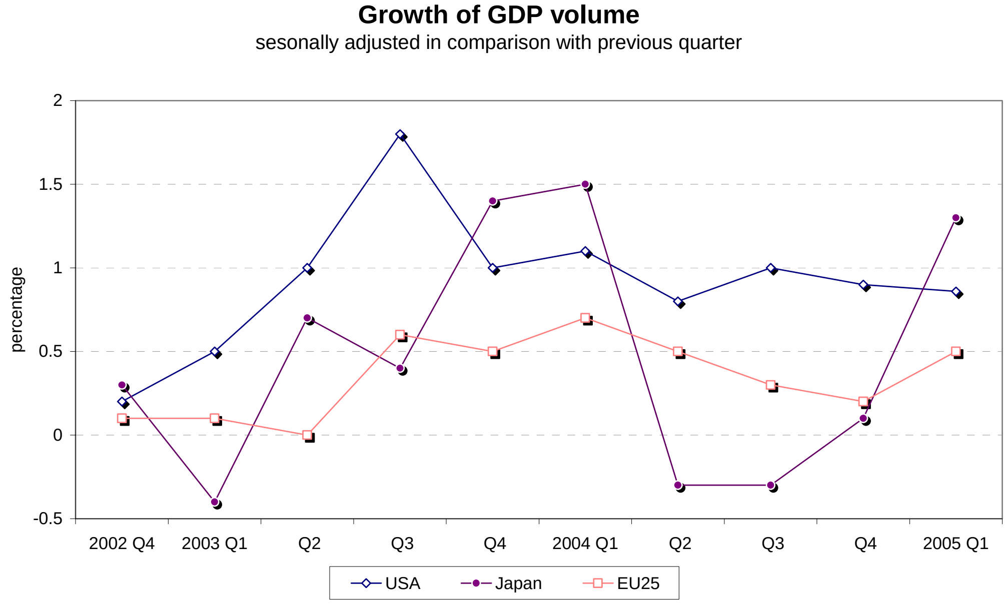
Global economic expansion to slow down in 2005

The data available until the end of June indicate the deceleration of growth in the first quarter and half-year, which is attributable to the high energy prices, more moderate domestic consumption and delayed effects of the previous Euro appreciation. Assuming the continuation of the favourable profitability and financing conditions, an economic upswing is expected starting in the second half-year. Based on the Q1-Q2 trends, the economic cycle indices and the forecasts relying thereon, an external economic upturn is expected for the entire year of 2005, even though its rate will be lower than last year.

IFO world economic climate

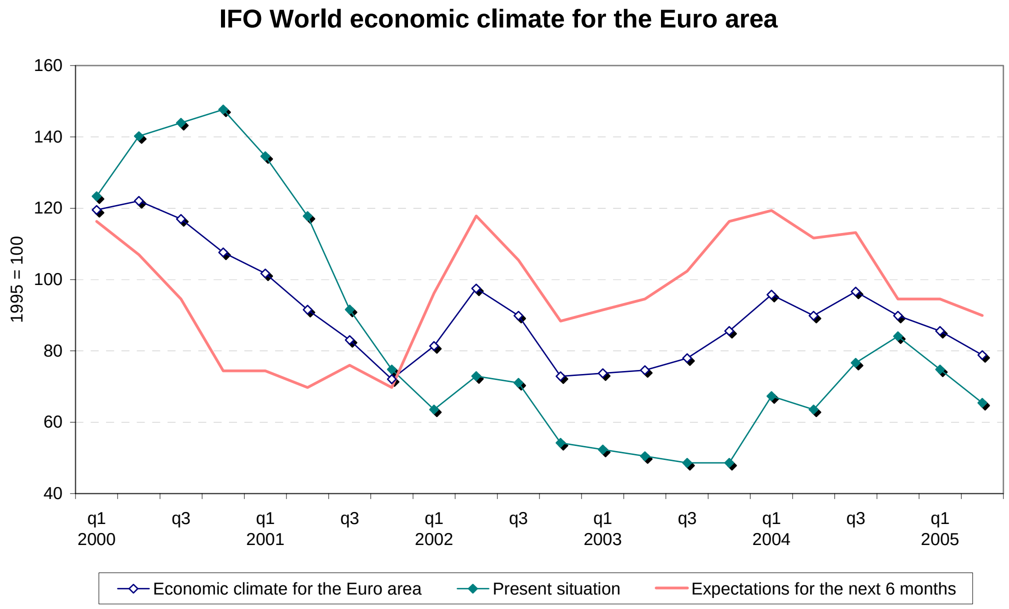


The IFO surveys of the entire global economy and the external markets of the EU, conducted at the end of June, forecast an improved business environment for the forthcoming half-year, which is shown by the flattening of the previously steep adverse trend.



In the world economy growth will continue to be driven by the US and the Asian countries other than Japan, mostly China, with the proviso that even in Japan the previous stagnation may turn into a slight growth. In Latin America, the relatively favourable growth rate will continue. Countries showing more vigorous growth owe their favourable developments primarily to internal demand – Asia, US (defence industry), Latin America, new EU Member States. It is mainly the import demand from these countries that generates the relatively favourable external demand environment for the other countries.

US and Asia continue to drive growth

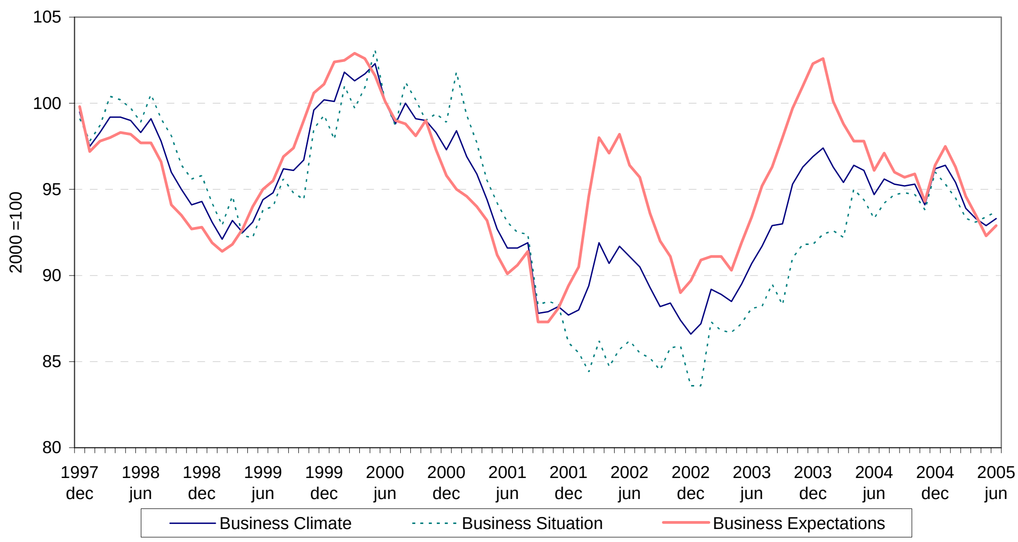


In the EU, the economic upturn will remain moderate in 2005, as the growth rate of the Euro area countries with the greatest economic potential decelerated slightly even as compared to the low levels of 2004. In the first quarter, GDP declined to 1.3% of the corresponding period of the previous year in the euro

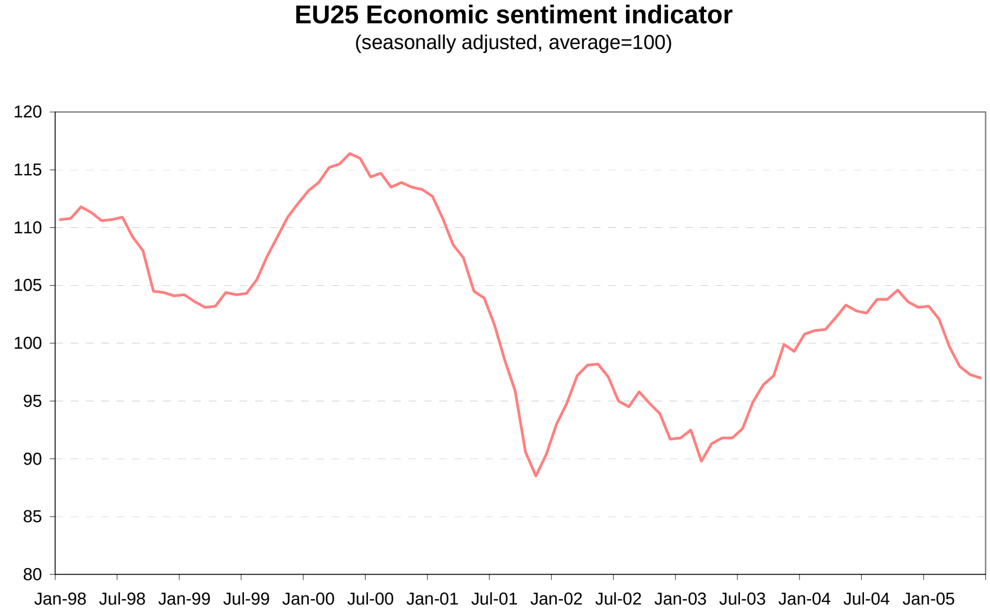
EU growth remains moderate, with no sign of radical change area (2004 Q1: 1.5%), and to 1.6% in the EU25 (2004 Q1: 1.9%). On the other hand, short-term indices signal an improvement: growth was higher, at 0.5%, both in the euro area and in EU25. Following a decline in three consecutive months, the industrial order book increased in April by 1.5% over the March level, which is also an auspicious sign. Business expectations in Germany, which is the most important country for us, improved slightly in June after deteriorating in three consecutive months. In the manufacturing sector, against the background of somewhat improving export prospects, expectations remained practically unchanged; in the construction sector deterioration continued, while the expectations of wholesale and retail trade are decidedly improving, especially looking forward to six months. However, the figures from a single month are not sufficient to allow us to talk about the reversal of the trend. Despite the probable decline in their growth rate, new Member States are expected to continue their more intensive growth.

Uncertain trend reversal in Germany

IFO Business climate for Germany



The deterioration of the composite business cycle index expressing the business and consumer expectation of the EU25 has been slowing down since April, remaining practically stagnant in May and June.

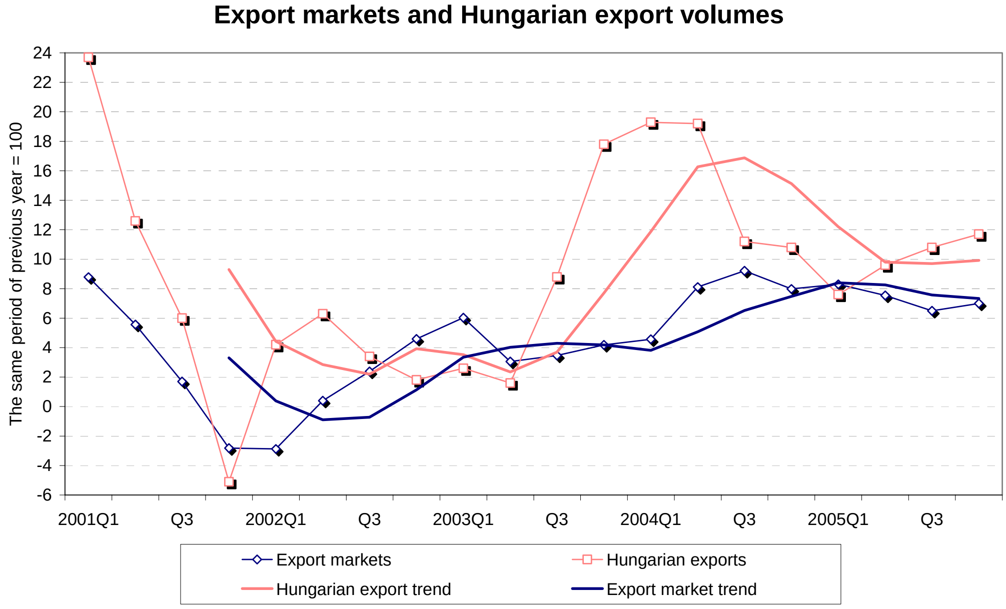


High oil prises represent increasing growth risk

Still, formerly existing risks continue to be present, indeed, they have increased recently. The price of energy climbed steadily, in several stages, beside the strengthening of the Dollar following the interest rate hike. In the last week of June, crude oil prices exceeded the 60 USD/barrel level, and are currently expected to remain above 50 USD/barrel in the long term, and expectations for even higher prices are not uncommon. The current prices, at around 60 USD, are higher in real terms than in 1973. According to analysts, however, an approx. 75 USD/barrel price would be needed to reach the 1979 level.

Thus the risks of the projected improvement in the economic activity have increased. On the other hand, good profitability, the still low interest rates and the liquidity of the capital market, as well as the favourable development of financing conditions allow for the possibility that global economic growth develops in accordance with earlier expectations.

From the aspect of Hungary, external demand, though its growth was somewhat lower than in 2004, remained relatively favourable.

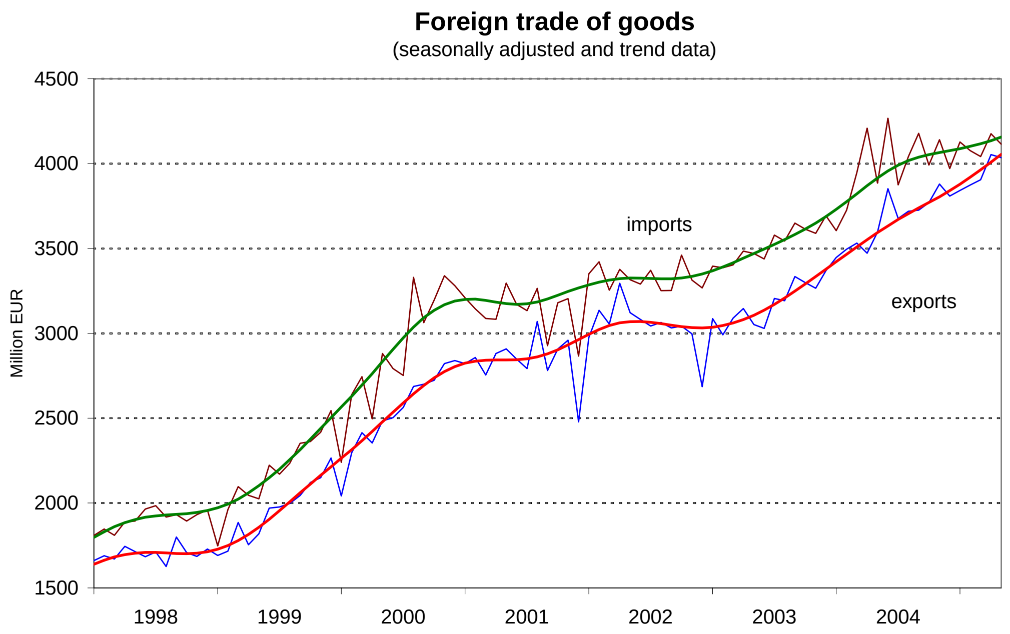


2. Growth factors

2.1 Foreign trade

Accelerating exports and imports again since early 2005

As a result of the sluggish external expansion, the growth rate of exports and imports decreased as from the second half of 2004, but early in 2005 it started accelerating again. Based on seasonally adjusted trends, the monthly growth rate of exports (over the previous month) fell from 1.3% in the first half-year to 0.9% in the second half of 2004. In the first five months of 2005, exports increased by 1.1% per month on average, reaching 1.2% by May. The monthly growth rate of imports declined more than that of exports after July 2004, falling from 1.2% in the first half-year to 0.3% in Q4. After March, the monthly growth rate of imports also accelerated, producing a growth of 0.4% on average in the first five months, and 0.5% in May.



Vigorous export growth, modest import increase

In volume terms, **exports** increased by approx. 10% over the base period in the first five months of the year; the almost 8% increase of Q1 was followed by above 16% growth in April and 10% in May. The dynamic export growth of April-May resulted from the expansion of the exportation of machinery (mobile phones, vehicle engines, passenger cars) and of crude oil products. The volume of imports expanded by approx. 3% in January-May 2005; the slow growth may be explained partly by the basis effect. In March-April 2004, prior to EU accession, import purchases of EUR 350 million were brought forward; net of that figure, import growth would be approx. 5%.

Developments in the real economy resulted in improved equilibrium

The **trade deficit** declined significantly in March and April, coming to EUR 1,081 million in the first five months, which is EUR 952 million less than in the base period. The improvement is partly attributable to the high basis due to import purchases brought forward, but the deficit declined significantly even if we disregard that factor. In January-April, the balance of trade with the EU Member States and non-Member States in Europe improved by more than EUR 1.6 billion. The improvement was attributable to the significant drop in importation in case of Member States, and the increase of exports in case of non-EU European countries. As regards Asian countries, a major increase in imports (63% in euro terms) resulted in a higher balance of trade deficit.

Worsening terms of trade

The terms of trade for Hungary worsened by 1.1% in the first four months of the year because of the rising crude oil prices, causing a price loss of almost EUR 200 million.

Substantial growth of exports of machinery, energy and cereals

In January-April[1] the **commodity structure** of exports was dominated by the almost 11% increase in the exportation of machinery, representing more than half of export growth. The volume of the exportation of manufactured products rose by 5.3% (exports of chemical, steel and iron products growing

[1] **Detailed** statistical figures by product and country group are available for the first four months; the following structural and country group assessment relies on such data.

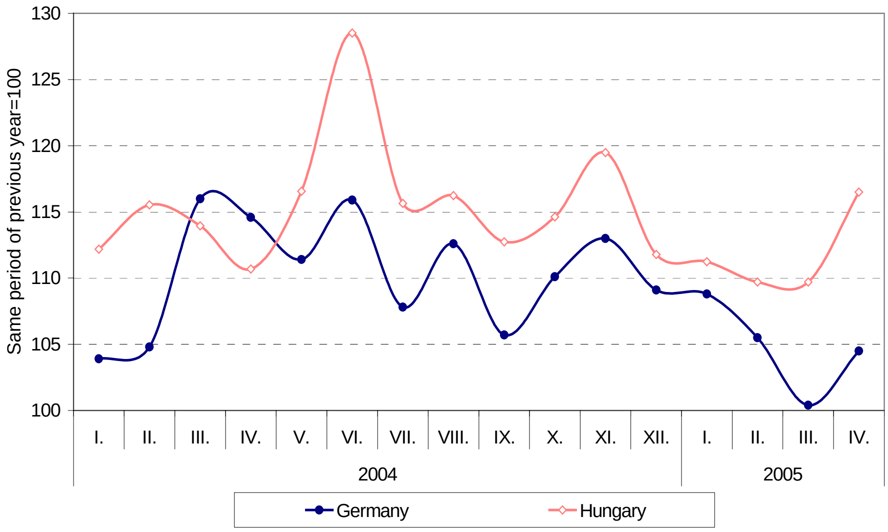
dynamically). The exportation of fuels (crude oil products) produced the most dynamic growth at 52%. The 17% growth of the exports of food products resulted from the significant exportation of cereals. Import growth originated essentially in the growth in fuels (crude oil) at 24% and of machinery at approximately 6%. The importation of food products also showed a significant growth (9.2%); their imports from Member States was up by 24%.

Machinery imports for reexportation and crude oil imports dominated

In terms of country groups, the volume of exports to the European Union increased by 4.6%. Our exports to the EU15 remained stagnant until March; within that, exports to France and Italy increased while exports to Germany declined. In April our exportation into the EU15 countries grew by some 6%, mostly due to the pickup of German import demand. Export trends show a close correlation with the import demand of Member States, in particular Germany. Because of our supplier activities (exportation of vehicle engines), Hungarian exports accelerate in line with the exports of Germany.

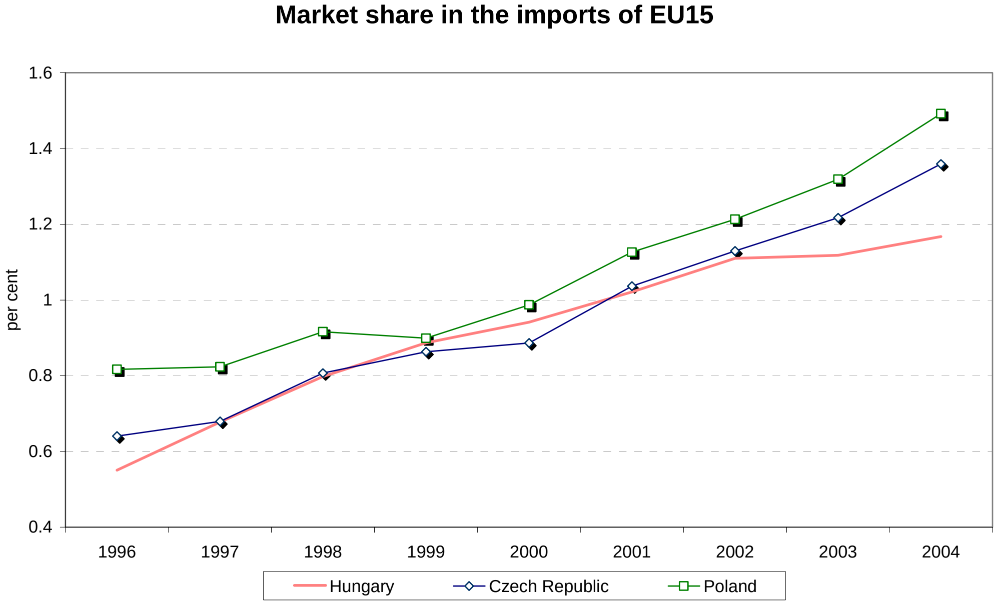
Our exports into Member States picked up after April

Exports of goods (million EUR)



As a consequence of the export expansion permanently and significantly exceeding the growth of external demand, our market share in the EU15 countries increased in 2004. However, our position relative to the Czech Republic and Poland has been deteriorating since 2001, and the stagnation of our exports to the EU15 in Q1 2005 is likely to bring about additional deterioration.[*/] In January-April, the exports of the Czech Republic and Poland increased at a rate higher than that of Hungary, and this is probably true for their exportation into EU15 countries as well.

[*/] Comparative figures are available only for the year 2004.



Our exports into new Member States have been increasing continuously at a rate significantly above the average since 2003 (by 25-30% in volume terms), and that trend continued in the first four months of 2005, the volume of exports growing by 42%. In respect of countries outside the European Union the volume of both exports and imports increased at rates exceeding the average: by 34 % and 28 %, respectively. Exportation into extra-EU countries in Europe (Russia, Romania, Croatia, Bulgaria, Turkey) increased by 54% in volume terms; our exports into the US also expanded significantly (by 23% in euro terms). In terms of imports, the importation for export purposes from Asian countries (Japan, China, Honk Kong) increased by 66% in euro terms, representing 80% of the import growth. As a result, our commodity trade became more diversified, the share of EU15 countries falling from 74% of our exports to 67%, and from 66% of our imports to 59% as compared to the base period.

Intensive expansion of exports continued into new Member States and non-EU countries within Europe

In 2005, the main risk lies in the external economic environment. Hungary's export growth hinges primarily on the import demand of the Member States. The improvement in April and May and the diversification of our export markets can be interpreted as favourable signs. If the existing import demand of Member States does not subside, or picks up (especially in Germany), export prospects can be even more positive than expected. Consequently, despite the modest external demand there seems to be a case for a 10-12 % increase of exports. Imports may increase at an 8-10% rate depending on the trend of investment in the business sector. This may result in a EUR 400 million, or even EUR 500-600 million drop in the trade deficit. No deterioration of the balance of services is expected; indeed, some improvement is possible, therefore, real economic developments are expected to lead to a significant improvement of the external balance.

Uncertain external expansion is a risk

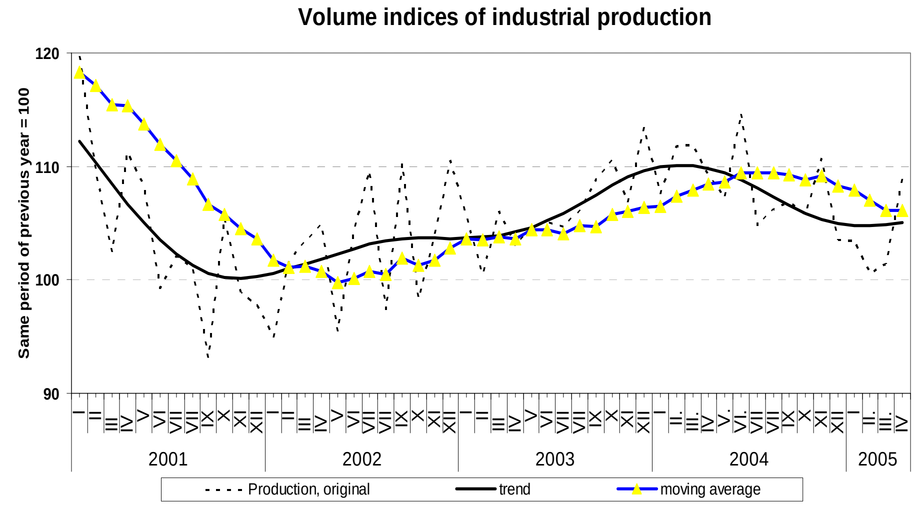
2.2 Output

Preliminary figures indicate that the upswing of **industrial output**, commenced

Upward trend of

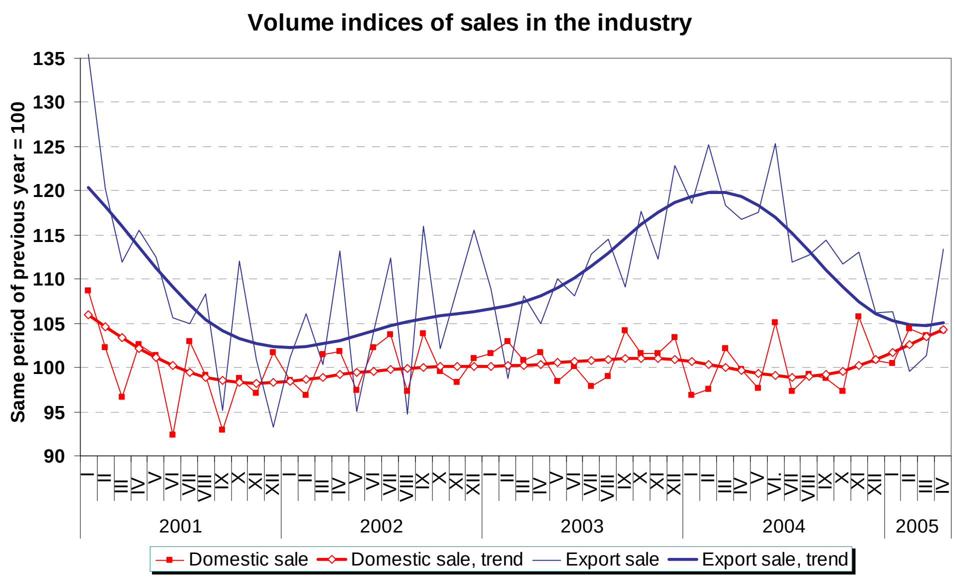
in April, continued; in May the rate of growth reached 12.9% over the corresponding period of last year (or 10.1% net of the effects of working days). The trend value of output increased in May, while the decline of the twelve month moving average came to a halt and the trend was reversed.

industrial output



Detailed figures are available up to April. After the slow-down in the first quarter, industrial production increased by almost 9% in April. The production growth of April was based on dynamically growing export sales (by 13.4%), but since the beginning of the year domestic sales also moved from stagnation to a definite growth path. Considering that, in addition to suppliers to multinational companies operating in Hungary, the small and medium sized enterprises are interested in the increase of domestic sales, thus, there is hope that the economic position of SMEs would also improve substantively. While the trend values of export sales all declined, even though at a decelerating rate (10.9% in April), the trend of domestic sales showed a monotonous growth (reaching 4.3% in April).

New trend: increasing domestic sales



Early this year, the long winter months increased the weight of the energy

Manufacturing

distribution sectors within industry, but in April the manufacturing sector could recover some ground: its output on a year-on-year basis increased by almost 10%, its foreign sales by 13.3%, and domestic sales by 4.6%.

picking up again

Within that, the output of the manufacture of electrical and optical equipment was up by almost 31% in April (15.4% during the year), and their domestic sales more than doubled and export sales grew by 17%. Among their products, domestic demand increased outstandingly for computers, being almost 20 times higher than the previous April level; in four months, 16 times more computers were sold in Hungary. On the other hand, the exports of computers was almost 30% below the previous year. The most successful export products of the sector are communication engineering equipment and components for transport equipment manufacturing.

The output of the manufacture of transport equipment increased by 14% in April (by 6% between January and April). Each month, the growth rate of domestic sales exceeded that of exports, sometimes considerably. The table below shows the production and sales of the two most important products of the sector.

The weight of engine and component production increased in the manufacture of transport equipment

Volume indices

January - April 2005	Output	Sales		
		Total	Domestic	Abroad
Road vehicles	0.4	1.8	-10.6	2.5
Road vehicle engines and components	17.1	17.4	43.4	14.5

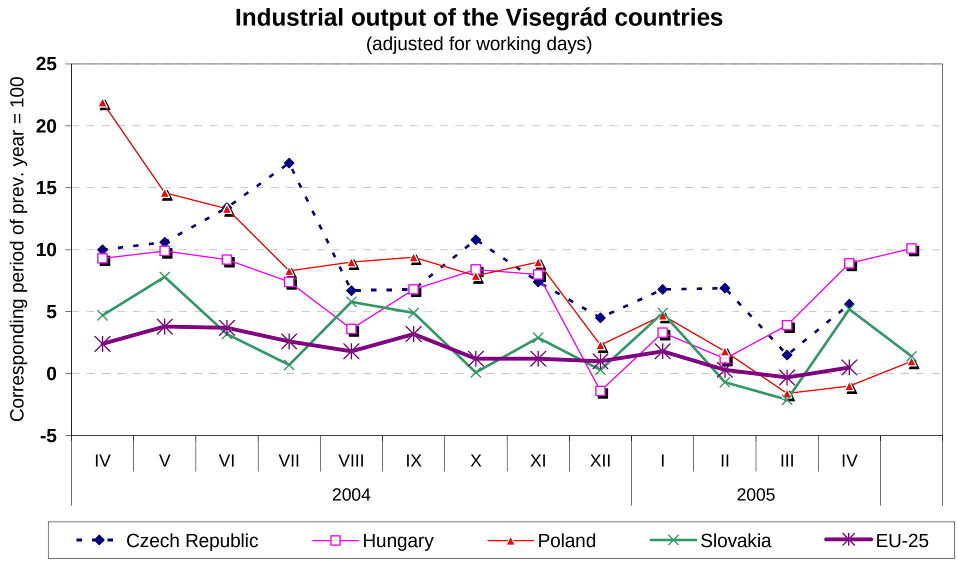
The high growth rate of the manufacture and domestic sale of the engines and components indicates on the one hand the conscious profile shift of manufacturers and at the same time the expansion of domestic supplier activities, and on the other hand the contraction of the (mostly domestic) demand for finished goods.

The output and domestic sales of the food industry declined by 10% in four months on a year-on-year basis. In the manufacturing sector there were no other significant structural changes since the previous year.

Despite pessimistic business confidence indices, in April the volume of new orders was 57% up on the previous April figure; such an increase has not been seen since January 2001. New export orders increased by more than 60%, new domestic orders by almost 30%. As a result of these positive figures, the order book was more than 8% up on the previous year figure.

Substantial increase in new orders

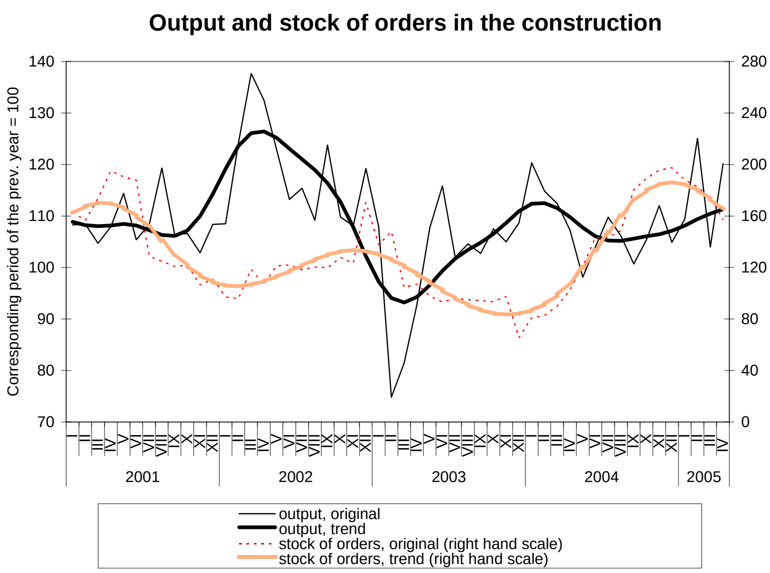
In recent months, the industrial outputs of the Visegrád countries were below the Hungarian figures (even though the May figures are not yet complete).



For the estimation of the 2005 industrial output, we assumed the external economic environment to developed along a similar path as last year. The growth rate of domestic demand at the beginning of the year is expected to last in the second half of the year too. At the same time, in light of the high manufacturing investment figure of last year it is likely that the appreciation of the logistical role of Hungary will create novel points of connection (assembly plants and establishment of service centres supporting logistical activities) for industrial producers. Taking into consideration all these factors, the growth rate of the industrial output in 2005 may come close to last year's 8%.

Vigorous growth of construction output

Last year's dynamic growth of construction was accelerated this year, primarily due to the road construction projects. Its output increased by 14.4% in the past four months. Both the trend and twelve-month ex post indices have increased, reaching 11.3% and 7.3%, respectively, in April.



The volume of new contracts, on a year-to-date basis, was 9.5% below the first four months of the previous year. The period-end order book declined continuously since the peak in December, but on the whole it was still 57% above the level in April last year.

Construction output for the year may reach 10 %

As the growth rate of housing investments is expected to subside in the second half of the year, this year's construction output will be driven mostly by the development of infrastructure projects. Taking into consideration the new potentials facilitated by EU accession, the output growth of the sector may be around 10% this year.

Good outlook for crops, declining livestock

The vigorous improvement of the profitability of cereals is attributable to EU transfers; this is likely to have urged farmers to step up cereal production in less favourable agricultural areas as well, which was complemented by the good weather similar to last year. Therefore it is possible that the crop this year will be close to last year's. As compared to the corresponding period of last year, the stock of cattle, pigs and poultry continued to shrink, as indicated by a survey of 1 April. With the exception of sheep, livestock declined in all major subsectors. As a consequence of the large supply, fodder prices dropped considerably, thus animal husbandry became more profitably, therefore a modest increase of livestock is expected for the whole of the year.

The bulk purchasing of agricultural produce increased by 9% in the first quarter, which resulted from the major upswing in the sale of crops, while the purchasing of livestock and animal products lagged behind last year's level (probably partly due to the explosive growth of import supply).

In the first four months of the year, the producer price level of agricultural products was 12% below last year's figures. (The producer prices of crops fell by 26%, those of livestock and animal products increased by 8%). In the same period, the expenditures of agriculture declined at a rate significantly lagging behind the decline of producer prices, at 2%.

If the weather remains clement, there is a reasonable chance that the level of agricultural output will come close to the outstanding figures of last year.

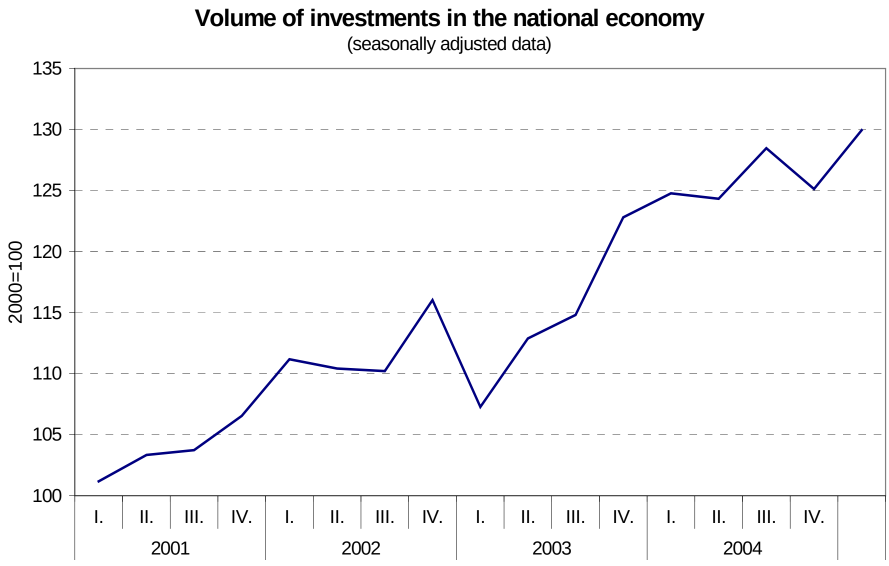
Substantial increase in transport performance in freight ton kilometres

The output of the **transport sector** in the first quarter increased over the previous year figures both in terms of the volume of goods transported and in freight ton kilometres. In freight transportation, international transport increased by 23%, while domestic transport by only 3%. The 48% growth of international passenger transportation was attributable primarily to the major increase of air passenger transport.

2.3 Investment

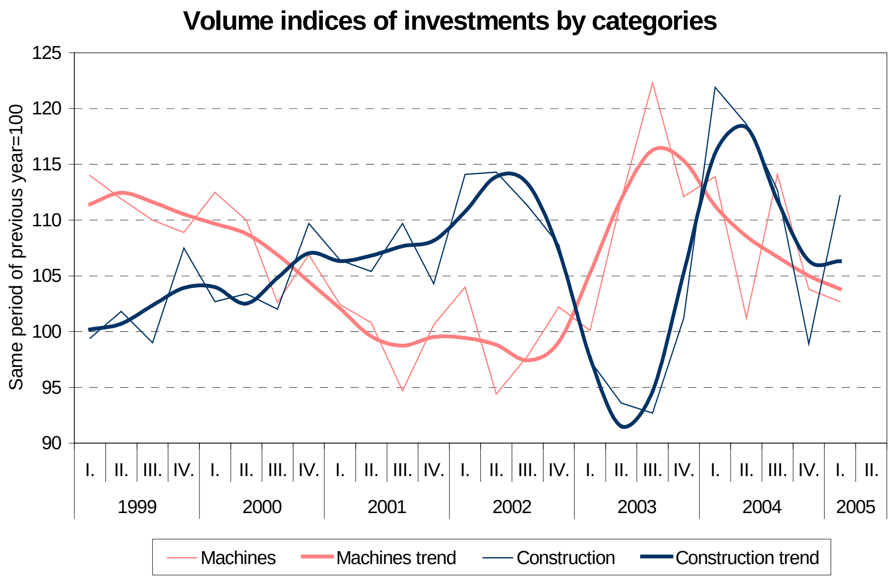
Resumed investment growth

The volume of investment in the national economy expanded dynamically in the first quarter of 2005 again, by 6,9%, after the modest performance of the previous quarter.

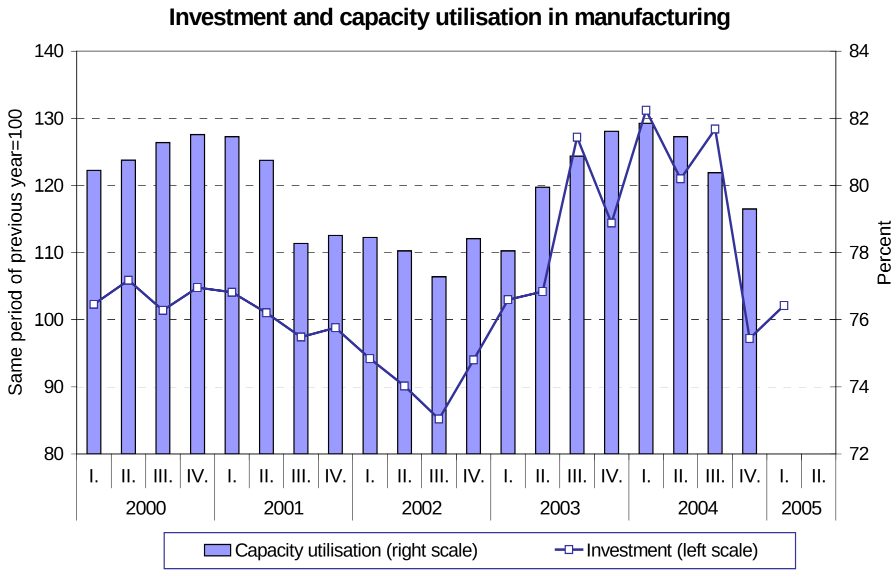


Construction investments predominate

The growth rate of construction investment was in the two-digit range again (12.2%), while that of investments in machinery increased slightly (2.7%). In the remaining part of the year the investment structure is likely to improve, as in the first quarter only one-eights of the annual investment activities tend to be realised.



The manufacturing investments that are essential for the acceleration of economic growth increased by 2.1%, in contrast with the over 30% growth in Q1 last year, which may be encouraging after the decline in the previous quarter. The capacity utilisation was around 80-82% for more than a year, while in Q4 it unexpectedly dropped by 3 percentage points. Consequently, the ratio of enterprises that assess their existing capacities to be sufficient for meeting the expected future orders has also grown.



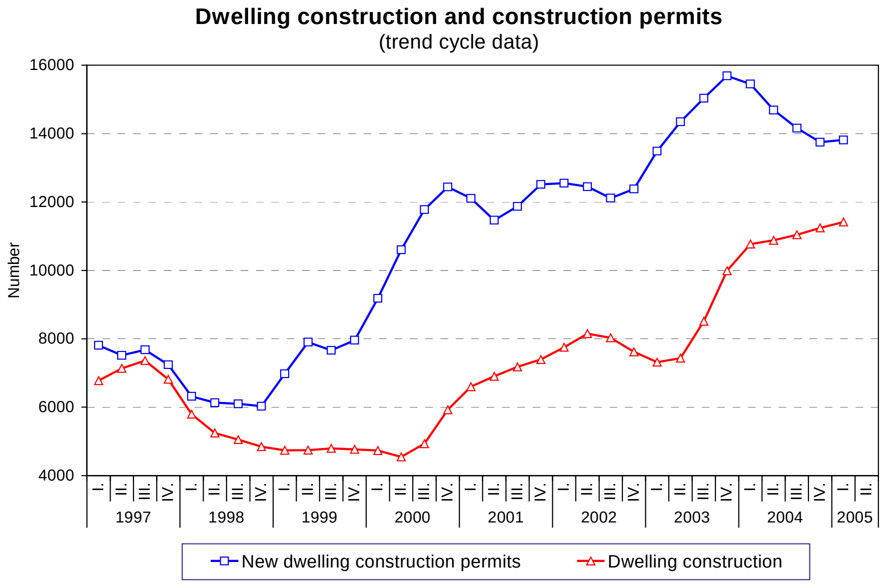
The stronger-than-expected investment performance of the first quarter is attributable mostly to the dynamic motorway construction: the transport branch produced an over 40% growth. On the other hand, the investments in the national economy branch of real estate transactions and economic business activities, which are responsible for over one quarter of investments, showed a 3% decline. This sector also includes dwelling investments, which performed below expectations because of the significant decline of average floor space.

High-volume motorway construction

In Q1 the number of dwellings put to use increased by 6.1%, while the number of construction permits issued dropped by 6.8%. On the other hand, partly because of the altered terms of borrowing, one and a half times the pervious number of single-room dwellings were built, thus the average floor area fell by 10 m^2 (86 m^2).

Increasing number of dwellings, shrinking floor space

In 2005, based on the downward trend of construction permits, the number of newly constructed dwellings may produce a slight decline as compared to the record figures of last year. In the first half-year, taking into account the average 5-quarter construction period, dwelling construction is likely to increase, but in the second half of the year a decline is likely.



Investment growth of 5-7 % expected

This year we calculate with more dynamic motorway construction, slightly moderating housing investments and a similar growth in business investments as last year. Based on the detailed figures of Q1 it appears that the 5-7% investment forecast for 2005 continues to be reasonable.

On the other hand, the uncertain business prospects on our export markets and the high oil prices represent downward risks, while the effective use of the available EU capital transfers, the volume of which is three time the last year level, may boost investment activities.

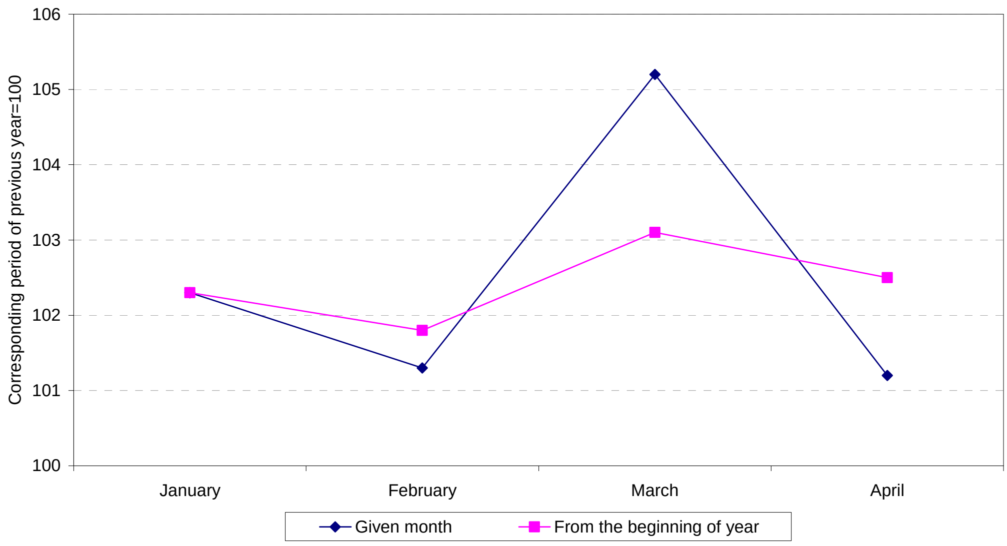
2.4 Retail trade, consumption

Growth rate of retail trade turnover lower than last year

In the first four months of the year, the rate of volume growth of **retail trade turnover** slowed down as compared to the previous year. The sales volume adjusted for the calendar effect and without the trade of motor vehicles and fuels was 4.3% higher in January-April than in the corresponding period of the previous year. The monthly growth indices varied substantially even after adjustment.

In four months, the retail turnover of the motor vehicles and vehicle components dropped by 3.2%. The number of new passenger cars sold was 7.5% lower in six months than in the first half of last year. In four months, the total turnover, without adjustment, increased by 4.3% at current prices, or by 2.5% at constant prices. The retail price level was only 1.8% higher than in the corresponding period of the previous year, while consumer inflation was 3.7%. The difference was caused primarily by the fact that the price of services and of household energy not included in retail trade was higher than average.

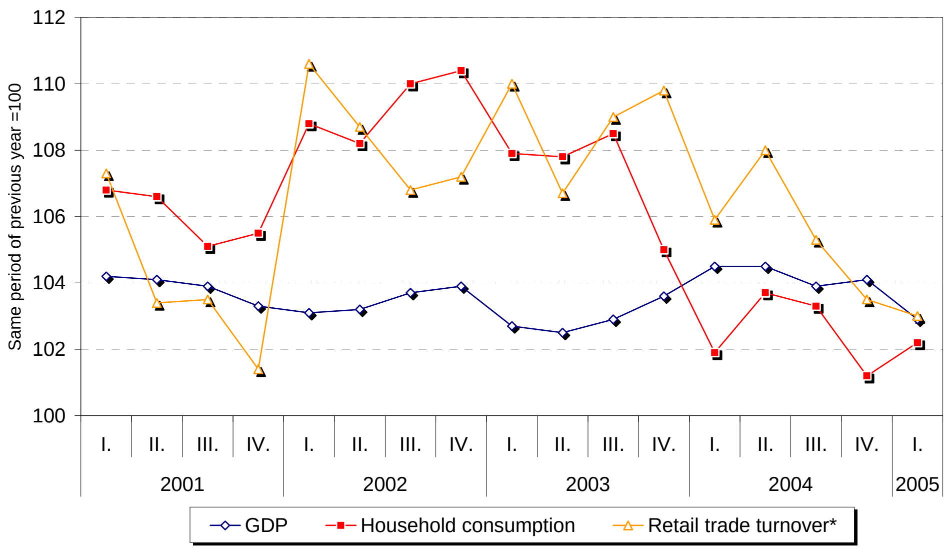
Volume indices of total retail sales in 2005



In line with retail trade turnover, the growth of the **consumption of households** also showed some decline. In Q1, consumption expenditures increased by 2%, in-kind social benefits by 3%, and household consumption in total by 2.2%. While last year the deceleration was attributable primarily to the decline of the outflow of income, this year the main reason for the declining growth was the increase of net cash savings.

Consumption growth slowed down

Quarterly growth rates



*Net of vehicles and fuel trade, adjusted for calendar effects

For the entire year, we reckon with a 3-3.5% increase of household consumption. In the second half of last year, the growth rate of consumption showed a declining trend, while in the remaining part of this year an upturn is expected, mostly due to the income outflow being higher than in 2004. The uncertainty of the forecast is caused primarily by the annual development of savings.

2.5 Labour market

According to CSO figures, the monthly average nominal earnings of persons employed full time in the national economy rose by 11.9% in the first four months of 2005 over the corresponding period of 2004. One cause of that increase is the change of the rules governing the payment of the additional one month salary in the budget sector in 2004; after adjustment for that factor, gross average earnings increased by 6.7% in January-April. This is in line with the 6-7% gross average earnings increase projected for the whole year.

6,7% gross average earning increase in the national economy

Indices of earnings and headcount in the first four months

in 2004 and 2005

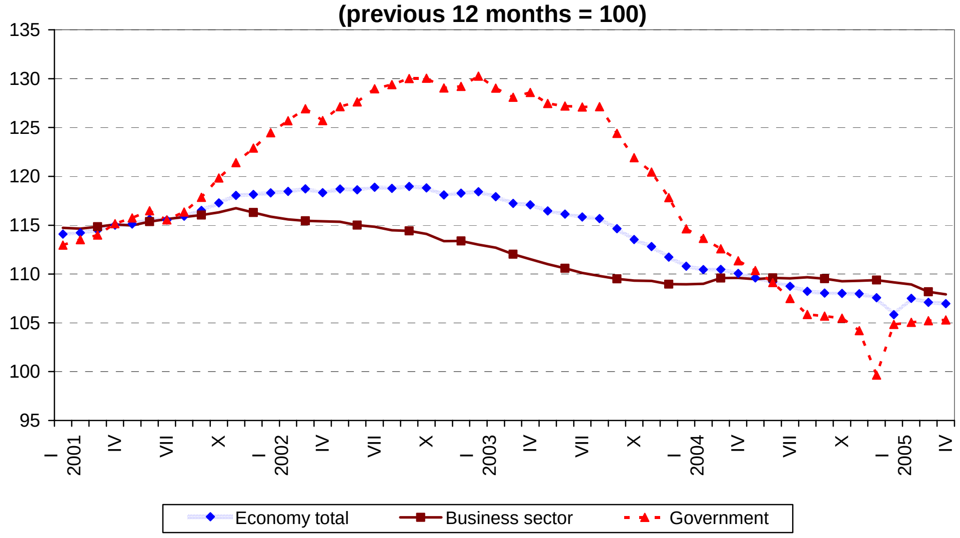
corresponding period of prev. year = 100 (%)

	National economy Jan-Apr		Business sector Jan-Apr		Budgetary sector Jan-Apr	
Year	**2004**	**2005**	**2004**	**2005**	**2004**	**2005**
Gross average earnings	109.1	111.9	111.0	106.5	106.1	122.7
Net average earnings	107.8	112.3	109.0	108.0	105.7	121.4
Real earnings	100.8	108.1	102.0	103.9	98.9	116.8
Headcount	100.8	100.0	101.4	100.4	99.1	98.6
*Adjusted gross average earnings**	*109.1*	*106.7*	*111.0*	*106.5*	*106.1*	*107.1*

* Adjusted for the effect of the one-month additional salary (MoF estimate)

In the first four months of 2005, gross average earnings in the entire business sector increased by 6-5%, at the expected rate, over the corresponding period of 2004. Within the branches of the sector, hotel services, catering (11.8%) as well as transportation, warehousing, postal services and telecommunication (8.0%) produced an above-average increase. Within the first four months, the wage outflow of March was below the average (5.3%); that lower earnings increase is attributable primarily to the fact that in 2004, departing from the usual practice, non-regular payments (bonuses, incentive premiums) were made in March.

Gross average earnings during the last 12 months
(previous 12 months = 100)



In the budgetary sector, the CSO showed a gross average earnings increase of 22.7%, which is partly attributable to the modification of the rule on the payment of the one-month additional salary. After adjustment for that factor, gross average earnings in the sector increased by 7.2% in the first four months. Within the branches of the budgetary sector, gross average earnings increased the least in social care (4.8%), and the most in public administration, defence and mandatory social insurance (8%) in the first four months.

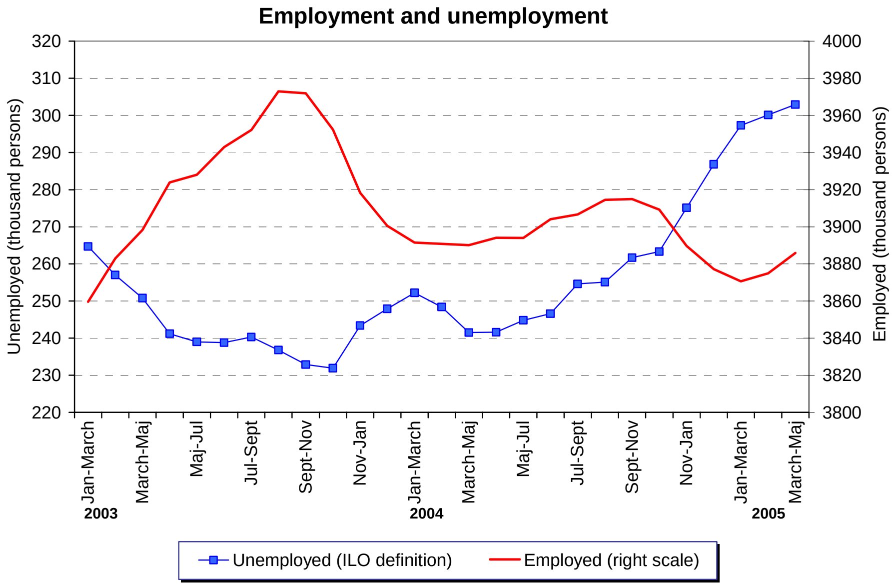
Real wage increase close to productivity growth in the business sector

In 2005, net earnings in the national economy increase at a faster rate that gross earnings due to changes in the PIT Act. Because of the abolition of the medium rate of the three-tier tax system effective in 2004, the tax burden was reduced primarily for taxpayers formerly falling in the medium or high brackets. In the first four months of 2005, net average earnings increased by 8% over the corresponding period of 2004 in the business sector, and by 8.4% in the whole of the national economy (net of the effects of the one-month additional salary). This corresponded to a 4.5% growth of real earnings in the first four months. The above figures are in line with the 8-9% net average earning growth and 4-5% real wage increase projected for the whole of 2005.

Stagnating number of employees

According to the institutional statistics published by the CSO, 2 million 776 thousand persons were employed on average in the first four months of 2005, the same as in the corresponding period of 2004. Within that, the headcount of the business sector increased by 0.4%, that of the budgetary sector declined by 1.4%. In the budgetary sector, the number of blue-collar workers declined substantially, by 3.3%, while the number of white-collar employees was reduced by only 0.8 percent. The headcount drop was the highest (2.7%) in health care. In the business sector it is worth noting that the entire 0.4% headcount growth of the first four months occurred among part-time employees: their numbers increased by 7%, while the number of full-time staff did not change on a year-on-year basis. It is likely that the spread of that more flexible form of employment was promoted by the fact that employers need to pay only a time proportionate part of the lump-sum health contribution in respect of part-time employees.

The figures resulting from the household surveys of the CSO, the coverage of which is wider than that of the institutional statistics as they also include employees of micro-enterprises (with less than five employees) and persons working outside employment relationships, reveal a similar trend. Accordingly, in March-May 2005, there were 3,886 thousand employed and 303 thousand unemployed persons on the labour market. The number of economically active persons increased significantly over the corresponding period of last year: the number of employees declined slightly (by 5 thousand persons), while the number of unemployed rose significantly by 61 thousand. On the whole, the pressures on the supply side have been slightly eased in the past period.



The number of employed persons increased again in May

Three-month indices show that the number of employees dropped significantly in the first quarter. The downward trend halted in April, and in May, for the first time after several months, it started to climb markedly, reaching the January level. Looking at the month of May separately, the favourable signs that could be expected based on the growth of industrial output and exports of April were already apparent. Even though the number of employees in the first five months of the year significantly lagged behind the 0.5-1% growth we had expected, in our forecast for the entire year we expect a modest expansion of employment, based on the slightly better macro-economic indicators of recent months.

Growing unemployment

The 7.2% unemployment rate of the 15-74 year-old age group, computed on a year-to-date basis, was 1.2 percentage points higher in the first five months of 2005 than in the corresponding period of 2004. The growth of unemployment since the beginning of the year came to a halt in May, as indicated by the monthly figures; indeed, it showed a slight decline (5 thousand persons). Despite the growth, the unemployment rate continues to be lower in international comparison than the rates of the EU-15 (8.2%) or the EU-25 (9.0%). In the March-May 2005 period the unemployment rate of young people (aged 15-24) rose to 19.2%. This is five percentage points higher than in the corresponding period of 2004, and in international comparison it exceeds the rates of both the EU-15 (17.2%) and the EU-25 (18.8%) for the same age group. This trend may be attributable to several factors: due to the good opportunities, more and more persons of that age group continue their education, thus they are less able to adapt to labour market needs; furthermore, the mandatory military service has also been abolished. The drop of some 33,000 in the number of that age group in 2004 itself increases the value of that indicator.

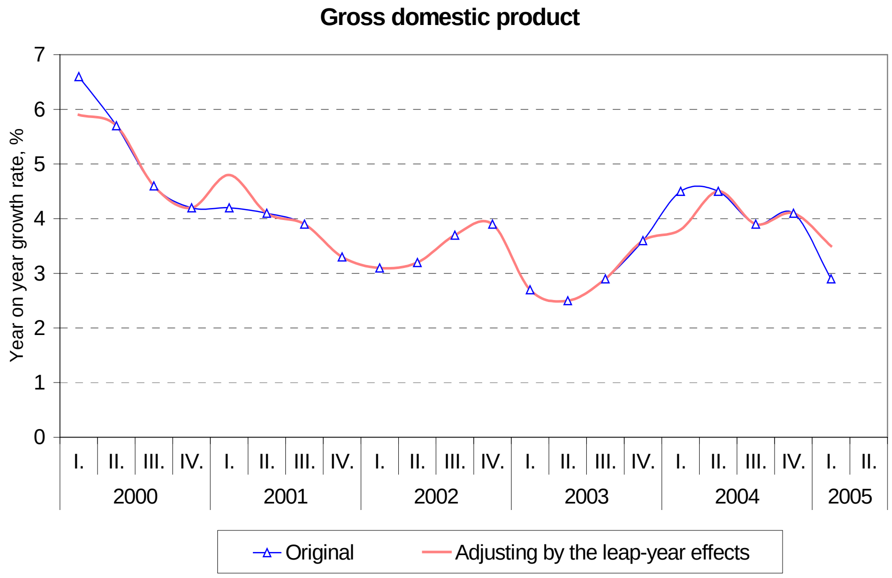
In the Visegrád countries, in Q1 2005 the Czech Republic was the only other country to have an unemployment rate below the EU-25 average (8.4%), while Poland (19.3%) and Slovakia (17.5%) had the highest rates within the EU. On the other hand, the number of employees increased in Q1 2005 over Q1 2004 in all these countries: by 2.3% in Slovakia, by 1.7% in Poland and by 0.6% in the Czech Republic. In the first two countries this is partly due to the fact that the number of persons taking up employment through cross-border hiring of labour increased substantially.

In the whole of 2005 the unemployment rate is likely to be around 6.5%. On the whole, a slight improvement of the employment rate and a more substantial improvement of the participation rate is to be expected.

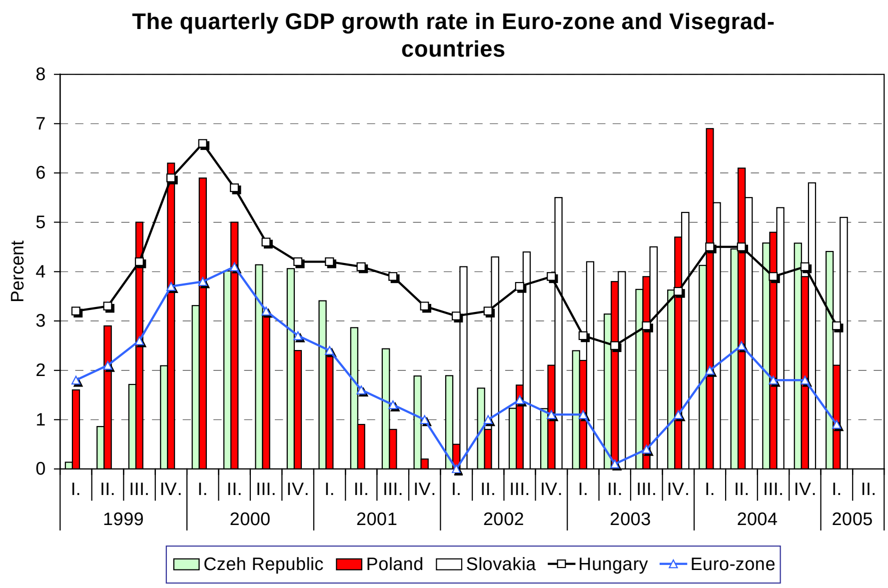
2.6 Gross domestic product

In the first quarter, the gross domestic product increased by 2.9%. However, economic processes are better reflected by the growth rate adjusted by the leap-day effect, which is considerably more favourable (3.5%).

> The CSO also adjusted last year's annual growth rate, because it implemented the methodological changes disclosed upon the publication of the year 2002-2003 national accounts (new developments in service statistics, modification of the calculation of the investment price index, changes in VAT settlement, etc.). In line with the new methodology, in 2004 GDP growth was 4.2%, and the growth rate adjusted for the calendar effect was 4.1%.

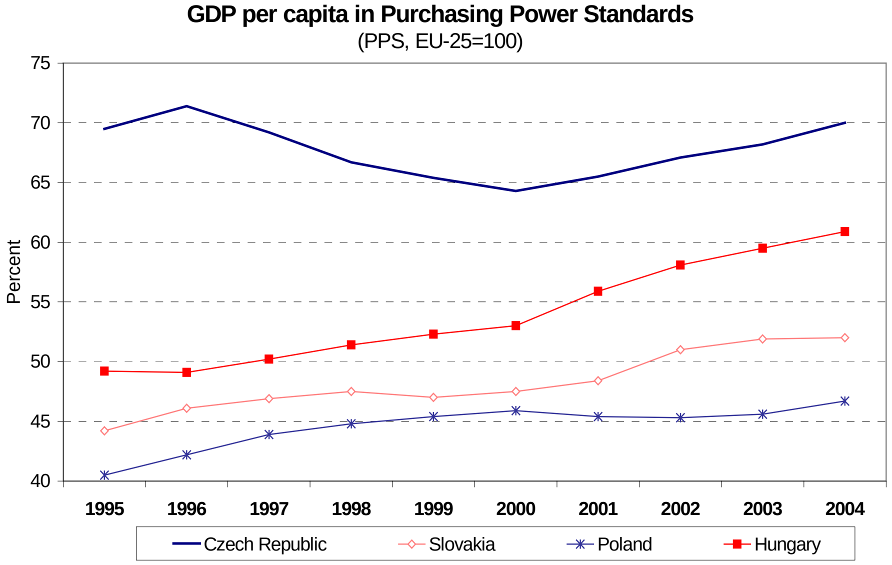


The growth rate in Q1 was over three times the average of the euro area. Of the Visegrád countries, GDP growth remained vigorous both in the Czech Republic and in Slovakia, while in Poland similar to Hungary, it slowed down. On the other hand, as an average of the past seven years, Hungary produced the most balanced and highest growth: while between 1997 and 2004 Hungarian GDP increased by 4.2% on average, the corresponding figure was 1.9% for the Czech Republic, 3.7% for Slovakia and 3.9% for Poland.



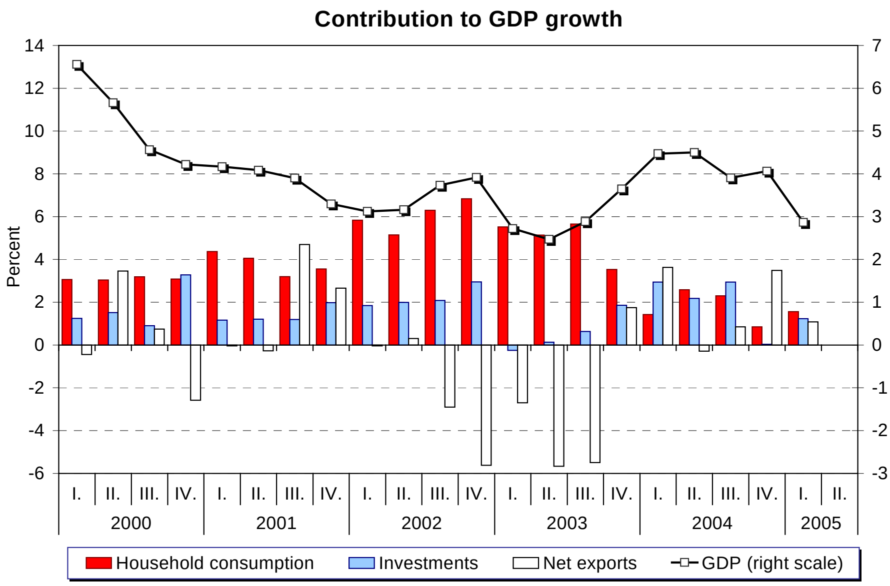
High and lasting growth in international comparison

In terms of GDP per capita in 2004 in Purchasing Power Standard, the Czech Republic (70%) and Hungary (61%) have approached the EU-25 average at the fastest pace, while the economic output of Slovakia (52%) and Poland (47%) lagged behind considerably despite their high growth rates. Looking at the 1995 figures, Hungary was the fastest of the Visegrád countries to approximate the EU-25 average (12 percentage points), while Poland achieved 7 percentage points, Slovakia 8 percentage points, and the 70% level of the Czech Republic disclosed in 1995 practically remained unchanged.



On the demand side, the GDP structure continued to be favourable in the first quarter. Underlying the economic growth there is dynamic investment activity, good export performance and moderate consumption growth.

…in a sound structure



In Q1 the growth of household consumption continued to be low, increasing at 2.2% a rate similar to previous quarters, which is slower than GDP growth. Growth continued to be driven by the dynamic increase of investments (6.8%), after the halt in Q4 2004. Because of the heavy decline of inventories, domestic absorption was only 1.7% up on the previous year figure.

Low consumption growth

The growth rate of the foreign trade of goods and services declined only slightly in the first quarter. Exports increased by 6.2%, imports grew at a slower rate

Considerable net exports

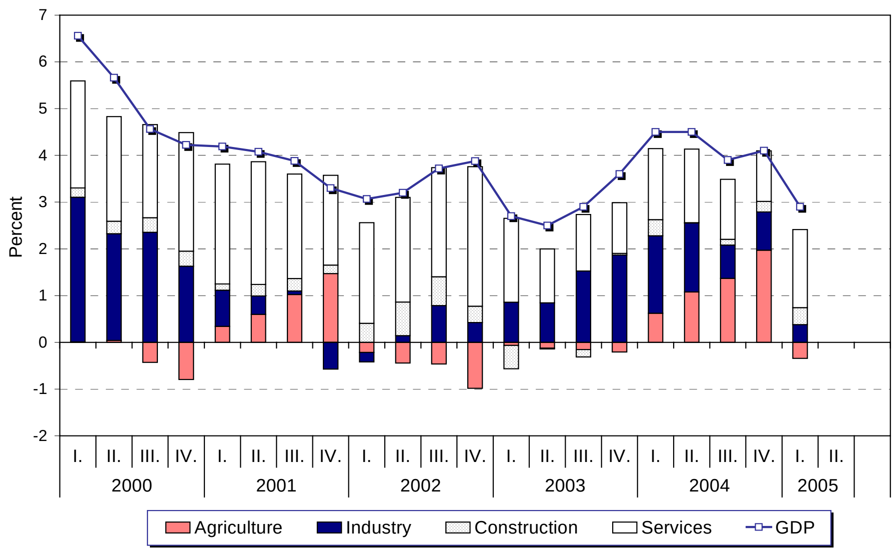
(4.8%). Net exports contributed significantly to economic growth (+1.1%).

For tourism, the CSO used the cash data in accordance with the old methodology for Q1 2005, while the basis contains the new statistical data. There is an important difference between the two data bases: according to the new statistics, exports were EUR 260 million and imports EUR 45 million higher in the first quarter. After adjustment for that difference, the January-March exports of goods and services increased by 7.6%, rather than the published 6.2%. Tourism exports did not decline (by 30%!), but increased slightly (approx. 2%). The new figure has less effect on import growth (5.0% instead of the published 4.8%).

The service sector is the main growth factor

For the first time since Q1 2003, on the production side economic growth was driven again by the improved performance of the service sectors (3.6%), and in particular transport, storage and communications, as well as hotels and restaurants. The lower-than-expected results of the non-service industries was attributable primarily to the 14% decline in the value added by agriculture and the modest growth in manufacturing (1.5%). The value added by construction produced a two-digit growth (12%) again.

Contribution to GDP growth



3.5-4 % growth for 2005

In the remaining part of the year we expect economic growth to intensify. On the supply side, services as well as industry and construction are likely to produce a dynamic growth since the beginning of the second quarter. Our GDP projection of 3.5%-4% for the year, as published in our April flash report, is likely to be realised around the lower edge of the range.

3. Inflation

Lower than projected inflation

In the past half-year the Hungarian economy adopted a more favourable inflationary path, as a result, **inflation in 2005** is expected to be lower than previously projected. As opposed to the former 4.5% forecast, the current inflation projection reckons with an annual average between 3.5-4%.

The price trends of the year so far have been determined by strong disinflationary processes started at the turn of 2004-2005. The inflation rate reached its lowest level in the spring months, and in the second half of the year it is expected to be on a balanced course with minor fluctuations.

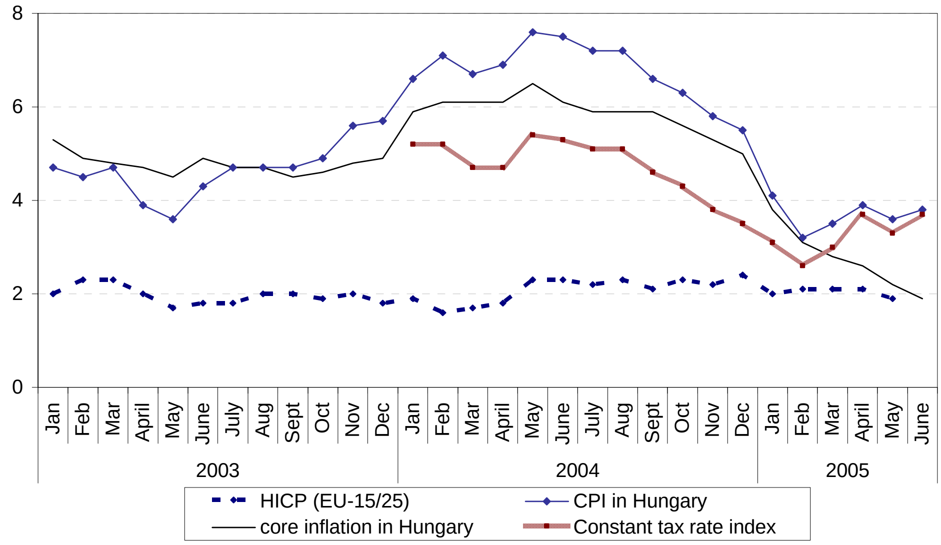
In line with earlier forecasts, inflation started to decline in mid-2004, however, stronger-than-expected disinflation occurred at end-2004 and early in 2005. This was attributable primarily to the slowdown of wage increases, the continuously strong exchange rate and the effects of EU accession on competition regarding both the supply side and the commercial sector, which is difficult to quantify but is still perceivable. These processes were hindered by the price increase of fuels and energy in international markets.

The figure below shows that, after the fade-out of both the effects of the VAT changes in 2004 and the substantial increase of international energy prices from Q2 2004, the price index has started falling significantly after Q4 2004, and now fluctuates in the 3.5-4 band.

The decline of the inflation rate, started in mid-2004, continued in 2005

Inflation trends in Hungary and in the European Union

change in comparison to the corresponding month of the preceding year, per cent

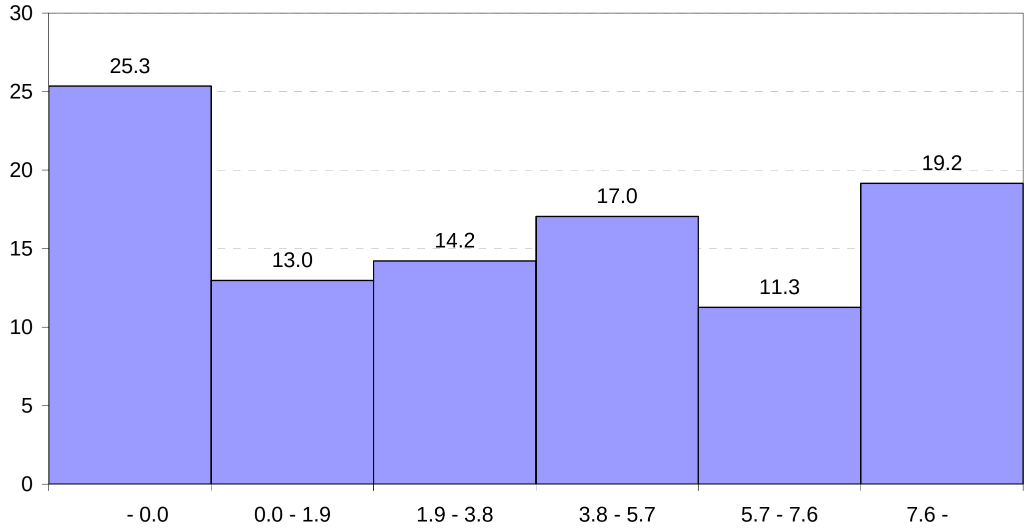


The core inflation trend promises sustained disinflation

Hungarian inflationary trends are parallel with those of the EU-25, while the autonomous disinflationary trend also relies heavily on domestic factors. The comparison of the Hungarian price index, net of tax changes, with the European trend reveals that even though the energy price increase did affect the Hungarian economy, the forces of disinflation proved to be stronger. As regards the forthcoming months, the core inflation indicator shows that disinflation is sustainable. The price changes of seasonal and energy sectors represent factors of uncertainty, nevertheless, the inflation rate will remain below 4%.

The figure below shows the wide dispersion of price changes underlying the twelve-month average inflation rate of 3.8% in May. There were price drops in case of above one quarter of the consumer basket, while close to one fifth of products and services produced a price increase more than twice as much as the average. It should be noted that both the greatest price drop (potatoes, -39.6%) and the largest price increase (pork fat, 43.9%) was found among food products.

Breakdown of products and services based on the 12-month inflation rate in June



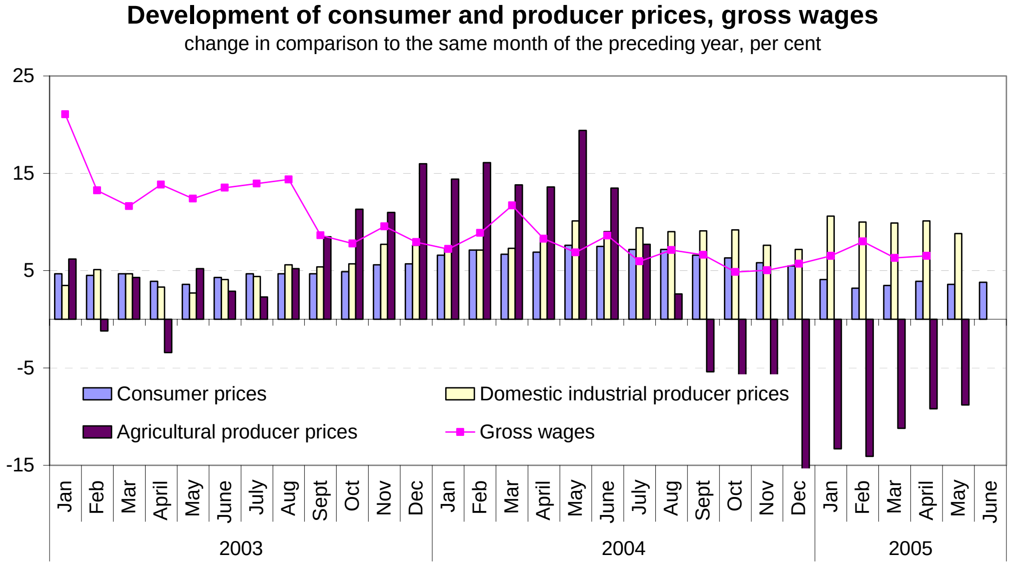
The dispersion of price changes indicates the relaxation of inflationary inertia

All this means that inflation now consists less in the "across-the-board price increases", and more in the shifting of price ratios. Inertial inflation lessens, different demand characteristics and consumption habits in various product and service groups are accompanied by different cost trends, productivity changes, commercial and import competition. As a result, the rate of inflation (or deflation) of various products and product groups is no longer determined primarily by general inflationary expectations.

The expected sustained disinflation is supported by several factors

As to the inflation expected for 2005, on the **supply and costs sides** the slowdown of wage increases, being increasingly aligned to the altered inflationary environment, certainly reinforces steady disinflation. As another argument for long-term disinflation, the decelerating expansion of household consumption, the slowdown of wage increases on the supply and cost sides and the relaxation of bottlenecks on the labour market bring about the deceleration of price increases of market services. In addition to the strong disinflation of the tradable sector, this also results in the deceleration of non-tradable inflation.

International and domestic producer and commercial competition continues to be strong, which creates a favourable inflation environment by checking producer prices. The moderating effect on prices of efficiency improvements forced by increasingly firm competition has further reduced the domestic inflation of consumer and clothing articles, and kept it below 2%, effectively meaning price stability. This is also true for an increasingly wide range of processed food products. The low price level of agricultural products that emerged in the past period moderates the prices of unprocessed food products. Based on expectation for this year, price levels are unlikely to change dramatically.



* Having eliminated the distorting effect of the altered regime of the payment of the one month extra allowance in the public sector, from the figures on December 2004 and January 2005

The wage growth rate gradually adapting to the changing economic environment

Analyses point to a scenario that the Hungarian economy will continue to operate in a European environment of moderate inflation. The Forint exchange rate is expected to follow a balanced course. In case of the dollar/euro exchange rate, the dollar may strengthen, or at least the level achieved in June may prevail. As long as oil prices are high, they will have a direct effect on increasing prices (energy sector, fuels), but as a result of keen competition the ripple effects on inflation would be moderate.

In terms of inflationary processes, decisive factors on the **demand side** include the increase of real wages in excess of last year's level, the moderate expansion of household consumption and the smaller decline of public consumption.

Based on the above factors, a 3.5-4% inflation rate can be projected. Risks are basically symmetrical, and inflation risk would be higher only if several factors (e.g. Forint exchange rate, international price trends, dollar/euro cross rate) changed at the same time, in an inflationary direction, which appears unlikely at this time.

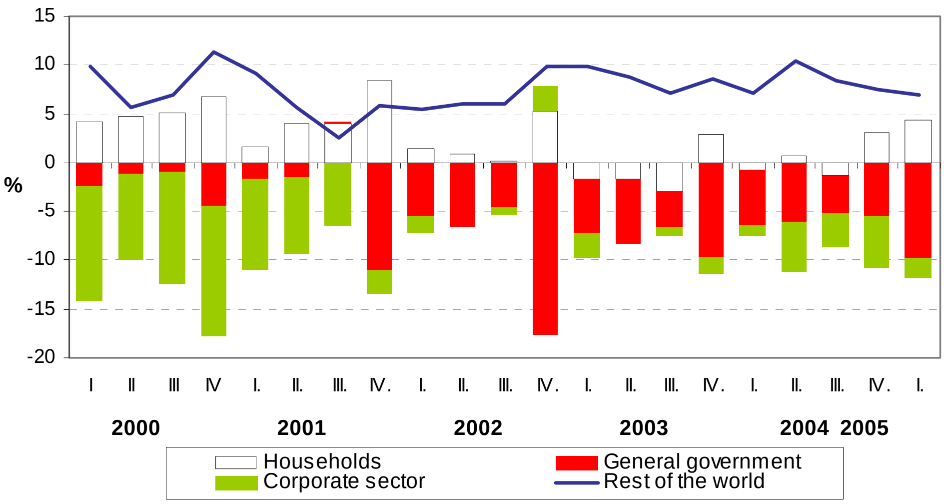
4. Income and financial developments

4.1 Equilibrium

The external financing requirement to GDP ratio gradually decreasing

As it emerges from the data of the financial accounts, in the first quarter of 2005 the external financing requirement of the Hungarian economy has been decreasing further for the third consecutive quarter. The external equilibrium indicator improved from 10.4% of GDP in Q2 2004 to 7.5% in the last quarter, and amounted to 7% of GDP in Q1 2005. In the whole of 2004 the net external financing as a percentage of GDP declined only slightly (8.4%), but the underlying internal structure moved in a favourable direction: household savings increased and the financing requirement of the general government declined. Thus, relating to the investment boom, the financing requirement of the corporate sector could more than triple over the previous year figure without the deterioration of the external equilibrium. The financing requirement of enterprises continued to be substantial in the first quarter of 2005 (non-financial corporations: -3.7% of GDP, financial and non-financial corporations together: -2.1%). As a result of seasonal and non-recurring factors, the general government deficit increased rapidly in the first half of the year, thus the drop in the external financing requirement was made possible mostly by the growth in the net financial capacity of households.

Financing requirement / capacity of sectors (in per cent of GDP)



Household savings may increase notably during the entire year over the 2004 levels, and they may reach 1.3-1.5% of GDP without private pension fund savings. The general government deficit will produce only a minimal increase in the second half of the year, and the financing requirement for the whole year will fall to 3.6% of GDP. The financing requirement of the corporate sector may increase to above 5.5% of GDP while the external financing requirement may go down to around 8% of GDP. (This forecast takes into consideration to external equilibrium indicator being improved by the EU transfers coming in through the capital account.)

4.2 General government

Following the more than 1.5 percentage point improvement of the balance, fiscal policy set out for this year to further reduce the general government deficit by almost 1 percentage point. The year 2005 budget includes an **ESA95 deficit for the general government**, including private pension funds, of 3.6% of GDP, after the approx. 4.5 %[2] in 2004, accompanied by a HUF 1,022 billion cash-based deficit on the central government level.

At end-June, the cash based deficit is 96.6% of the annual

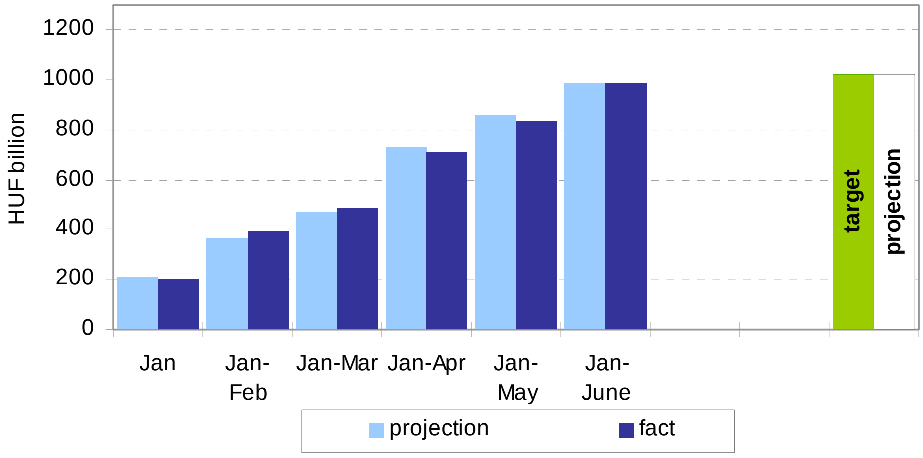
Based on the interim cash data, the deficit of the central government (central budget, social security funds and extra-budgetary funds) reached 96.6% of the annual appropriation by the end of June. The deficit developed in line with the

[2] Preliminary figure (March 2005)

monthly updated projections, which reckoned with the faster growth of deficit in the first half of the year due to seasonal factors. In January-June, a deficit of 798.6 billion was generated in the central budget (114.1% of the annual appropriation), and HUF 220.6 billion in social security funds (64.6%), while the balance of the extra-budgetary funds showed a surplus of HUF 31.3 billion.

appropriation, in line with projections, …

Central government deficit in 2005



On an accrual basis, the semi-annual deficit is more favourable because the cash-based deficit was increased by items carried over from the previous year (VAT reimbursements relating to Q3 last year, national subsidies supplementing EU agricultural transfers), which were already included in the ESA 95 deficit figure for 2004.

... the accrual based deficit is lower

In addition to payments carried over from last year, the deficit is also attributable to seasonal and non-recurring factors: some expenditures are incurred at the beginning of the year rather than gradually during the year (one-month additional salary in the public sector payable pursuant to legislation, agricultural subsidies, payments for motorways, etc.), furthermore, interest expenditures are also distributed unevenly during the year. Even though the balance was improved on the revenue side by the non-recurring revenue of HUF 178 billion from the change of the financing arrangement of motorways, this is offset by the faster realisation of tax revenues at the end of the year (corporate profit tax payment, personal income tax, VAT revenues from more intensive consumption at year-end).

Additional expenditures at the beginning of the year

Based on the semi-annual figures, the largest tax revenues of the central budget fall short of the time-proportionate levels: by the end of June, 36.8% of the annual appropriation of the value added tax was collected (or 43% net of the reimbursements relating to Q3 of last year), and the corresponding figure for the personal income tax was 45.3%. Even though wage increases are likely to be greater and consumption growth more dynamic than envisaged at the time of the budgetary planning, the favourable effects on revenues are hindered by the slower employment growth and lower inflation rate.

Revenue shortfalls and...

change over previous year, %

	2005 budget (September 2004 forecast)	July 2005 forecast
Gross average earnings	5 - 7	6 - 7
Number of employees	0.5 - 1	0 – 0.5
Volume of household consumption	approx. 3	3 – 3.5
Consumer price level, annual average	approx. 4,5	3.5 – 4

Taking into consideration the base effect (actual revenues in 2004 turned out to be lower than projected at the time of the preparation of this year's budget), on the whole, a shortfall corresponding to approx. 0.8% of GDP is to be expected in the accrual-based tax and contribution revenues.

... excess expenditures...

On the expenditure side, the six-month expenditures of both the central budget and the social security funds exceeded half of the annual appropriation. In the whole of 2005, pension expenditures are expected to be higher than budgeted, and measures need to be taken to prevent the overrun of the pharmaceutical subsidy appropriation. In the central budget, the expenditures concentrated in the first months (one-month additional salary, agricultural subsidies, motorway payments) also contributed to the net expenditures (without expenditures covered by own revenues or EU transfers) of budgetary institutions and chapter managed appropriations reaching 57.6% of the appropriation in half a year.

...are offset by measures, thus...

In light of the interim processes, the Government adopted measures to attain the deficit target:

- of the increased extraordinary general government reserve, HUF 125 billion will be saved definitively (0.6% of GDP);
- in the field of pharmaceutical expenditures, a fix subsidy scheme based on the active ingredients in case of groups where the subsidy amounts to 100% was introduced as of 1 July 2005;
- the amendment of the Gambling Act, the change of the import VAT collection system from third countries (outside the EU), the widening of the social security contribution's base and tighter controls on the importation of tobacco products will increase revenues;
- furthermore, the expansion of the new financing system of motorway construction, the continuation with private financing of more sections than originally proposed will imply less burden on the budget than originally assumed.

Taking into consideration the impacts of those measures, the proposed annual deficit of the general government is possible to maintain. The second half-year will not be burdened with additional expenditures similar to those incurred at the beginning of the year; furthermore, the requirement relating to the obligation of budgetary institutions to retain their residual appropriations and the blocking of general government reserves will become effective in the second half of the year.

... the annual

In the context of the structure of the debt, the timing of interest expenditures (large interest expenditure in excess of 0.5% of GDP in June, while only 0.1% of GDP in July) is one of the reasons for the surplus expected in the cash-based balance of the central government in July. As a result of the year-end tax receipts (corporate profit tax, VAT), a surplus is expected again in December. On the whole, the ESA deficit for 2005 (together with pension funds) continues to be expected at 3.6% of GDP. (In its Communication of 13 July 2005, the Commission recognised Hungary's attempts to adjust for the year 2005 deficit and considered the measures taken to realise the appropriation to be effective.)

budgeted deficit can be maintained on the whole

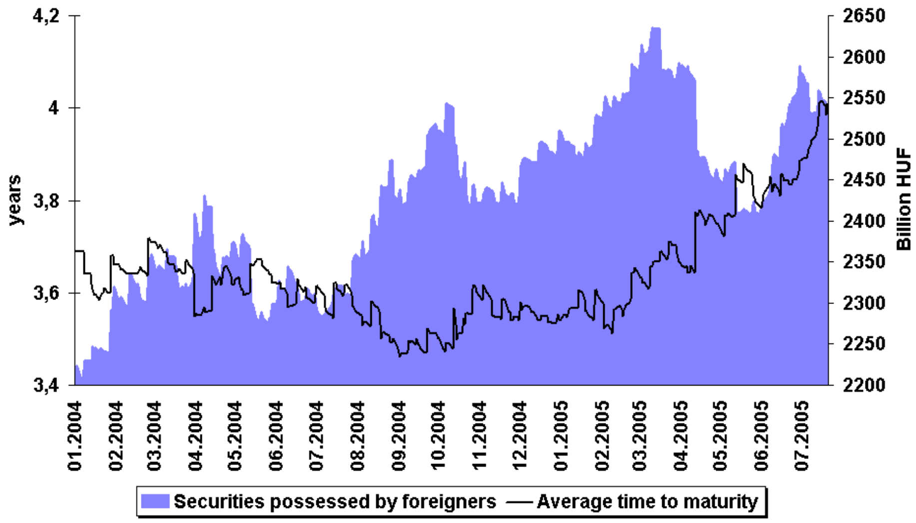
In the first five months, the **debt of the central government** increased by HUF 1050 billion, in excess of the time proportionate level, mostly due to the uneven development of the budget deficit during the year. That is because a significant part of the deficit has been concentrated in the past period due to usual seasonal effect and non-recurring, temporary factors, therefore the debt of the central budget will increase only slightly in the remaining part of the year.

The debt trend is determined by the development of the general government deficit

In accordance with the reviewed debt management strategy, in 2005 the ratio of foreign currency denominated financing increased, at the same time that of Forint funding decreased, that is, the Government Debt Management Agency assured the financing of the deficit mainly through foreign currency denominated government bonds concentrated in the first half of the year. As a result, by early July the total foreign exchange denominated government bonds proposed for the year have been issued, thus in the first half-year the ratio of direct foreign currency financing increased. The share of non-residents in the financing of the debt fluctuated around 47-50%; within that, the increase of foreign currency financing went hand in hand with the decline of their role of Forint financing.

In the first half-year the conditions of financing were favourable. In case of foreign currency denominated government bond issues, the announced volume was issued, and in the case of the US dollar denominated government bonds of February, responding to the substantial excess demand, one and a half times the announced volume was issued above the previously determined premium band. Meanwhile, inverstors' interest was average on the Forint market, thus the announced volume, or more in case of excess demand, could be allocated, in an environment of falling yields.

Hungarian government securities posessed by foreign investors



4.3 Financial savings of households

Seasonally high net position in Q1

In Q1 this year the net saving position of households amounted to HUF 292.5 billion. Underlying the seasonally high amount there is moderate credit demand and strong propensity to save due to the considerable income outflow during the quarter.

Continued increase of foreign currency borrowing

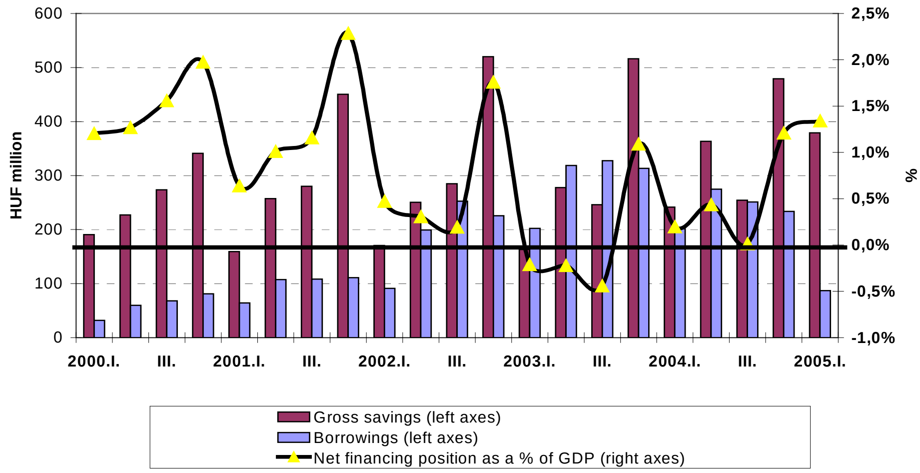
In Q1, the credit stock expanded considerably slower than in previous years, amounting only to HUF 86.8 billion. This is due to the very low volume of borrowing for housing purposes, at HUF 44 billion, which is explained by the delays in the launch of the “Nesting” programme and the unusually long winter weather. The spread of foreign currency loans continued. In the first three months of the year, household borrowed 85% of their new loans in foreign currencies, which is explained by the significant foreign currency-Forint interest differential existing despite the falling Forint interest rates. The foreign currency loans already represent some 25% of the total loan stock, which increases the risk of an adverse effect of a potential exchange rate shock on households.

The significant increase of the revenues of the sector had a major effect on savings, which was attributable to the payment of the 13th month salaries of the public sector in January and the one-and-a-half week portion of the 13th month pension in March, as well as the precautionary motif because of heightened fears of unemployment.

The decelerating rate of indebtedness and the seasonally high value of gross savings had the result that the net financing capacity of households in the first quarter reached 1.3% of the (annual expected) GDP or, taking into consideration the effects of the pension reform[3], 0.5 %of GDP.

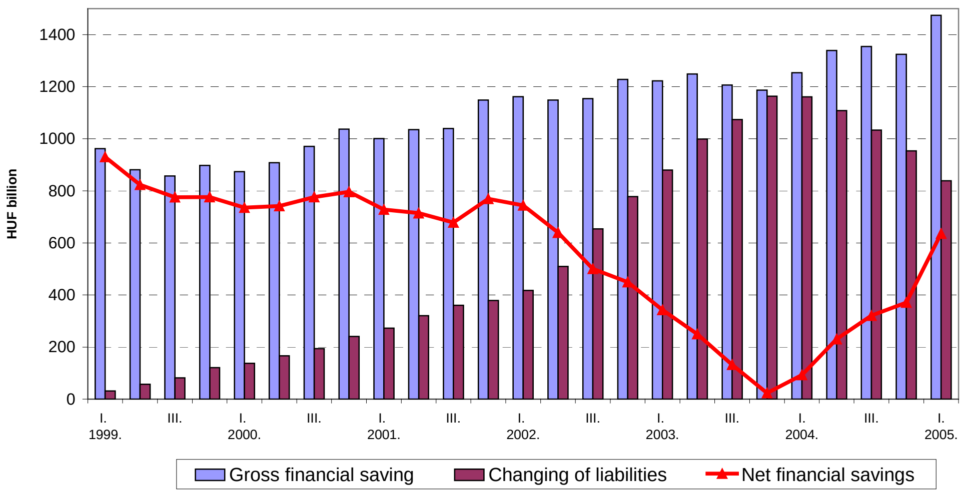
[3] The data do not contain payments to mandatory pension funds - in concert with the general government methodology - for those do not constitute savings based on people’s discretionary decision.

Development of gross savings and borrowings of households and their net financing position as a % of GDP



The strengthening net saving position is illustrated by the 12-month cumulative figures: the growth started in the last quarter of 2003 remained unbroken in the reporting quarter, as a result of which the value of the 12-month net financing position of the sector was already above HUF 600 billion.

Development of net financing position of households (12 month accumulated values of transactions)



In 2005 prudential considerations and the high debt service burden as a proportion of income, as compared to the level of indebtedness, is likely to exert a significant influence on the savings behaviour of households, resulting in moderate credit demand and increasing gross savings.

In light of the above, the net position of the sector as a proportion of GDP may increase slightly this year, reaching 2.5%, or 1.2-1.5% of GDP taking into consideration the effects of the pension reform.

4.4 Corporate sector

The financing requirement of non-financial enterprises increased

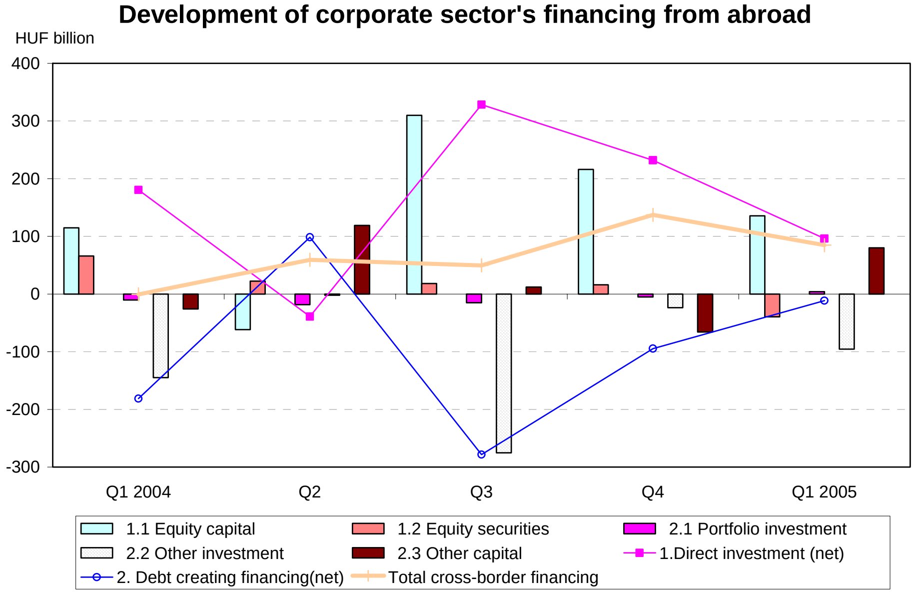
According to the comprehensive data of the financial accounts of the national economy, in Q1 2005 despite the effects of the poor business environment, a financing requirement of HUF 124 billion arose in the corporate sector[4], which is the highest among the Q1 figures that have been gradually increasing for years. The financing requirement of non-financial enterprises amounted to HUF 179 billion, which was reduced by the expansion of the financing capacities of other financial enterprises.

Continued decline of the growth of domestic bank financing

Hungarian banks contributed to satisfying the financing requirement of the sector with HUF 255 billion net credit, which is higher than the average of the previous periods, but indicates the continuing trend of the declining share of Hungarian banks in financing, relinquishing ground to foreign banks.

Indebtedness growth continues to be driven by the expansion of net foreign currency borrowing. However, within that increase, the ratio of foreign currencies declined considerably since the middle of the previous year (91%), and amounted to less than 60% at the end of the first quarter. Apart from the more reasonable Hungarian interest rate levels, this may have been attributed to the greater awareness of foreign exchange risks.

Development of corporate sector's financing from abroad



4.5 External equilibrium

Declining external financing

The balance of the current account and the capital account together show the net external financing requirement, which was EUR 1.3 billion at the end of

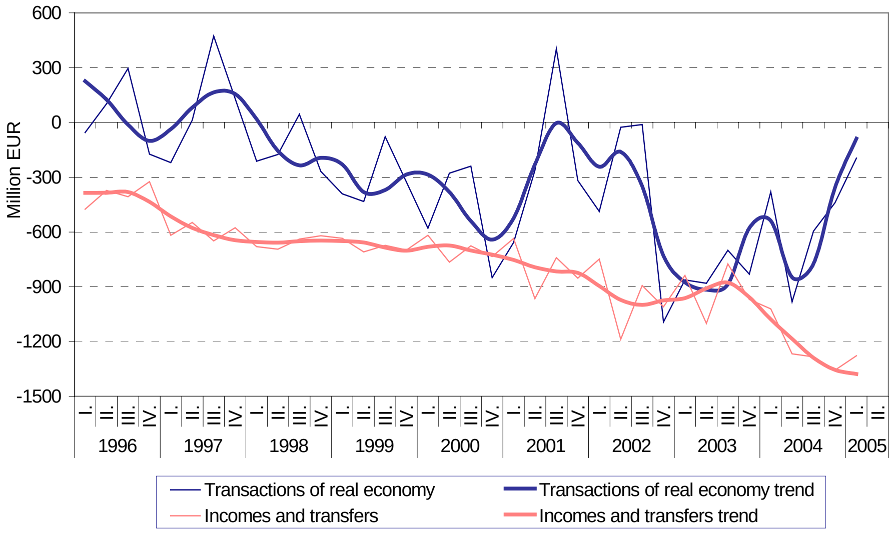
[4] without credit institutions: S11+S123+S124+S125

March, essentially the same as last year. However, in proportion to GDP, there was a decline of almost 1 percentage point (from 7.6% to 6.7%) due to the GDP growth.

requirement/GDP ratio

At the end of March, the current account deficit was EUR 1.5 billion, or 7.5% of GDP. This represents an EUR 190 million, or 0.2% of GDP growth over March last year. Within this, the deficit of the balance of real economy transactions declined, which indicates a substantive improvement of the structure of the economy. The continuous increase of income transfers results primarily from the expansion of activities of non-residents in Hungary. The ratio of the stock of FDI to GDP is substantial (59.8%), therefore profit transfers are high and so is the ratio of reinvestment.

Transactions of real economy, incomes and transfers



In Q1, the improvement started in the second half of 2004 in the transactions of the real economy continued, the balance of products and services improving by almost EUR 170 million. This is attributable partly to the more sound consumption structure of the economy and partly to non-recurring technical reasons.[5].

The external trade deficit fell by some EUR 200 million to EUR 189 million, exports improved by 11%, imports by 9%.[6]

Services produced an expenditure surplus of EUR 22 million, which represents a slight deterioration on a year-on-year basis. The EUR 300 million surplus of tourism was offset by a similar magnitude of deficit of other services. However, the deterioration of the balance of tourism halted, and the value of export revenues increased by 10%. At the same time, expenditures increased by 16.5%, though over a lower level. The increase of revenues from other services

[5] Non-recurring technical effect: in the first half of 2004, the import purchases brought forward prior to EU accession and the clearance of temporary importation accompanied by an SCD had a significant adverse effect on the current account. The effects of this will be present even in the second quarter.

[6] The balance of payments contains data in euro. In the first quarter, the volume of exports, according to the preliminary figures of the CSO, increased by 8.2%, that of imports by 4.5%, thus export growth was 3.7 percentage points more dynamic.

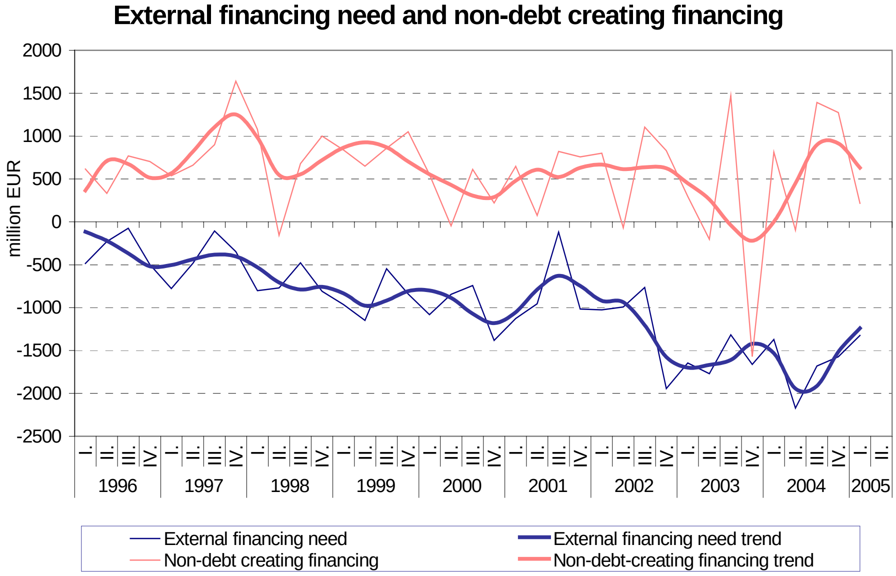
(7.6%) was exceeded by the more dynamic growth of imports (9.3%) over a higher level.

Transfers of incomes increased by EUR 257 million. 70% of the almost EUR 1.3 billion net income transfer related to non-debt creating investments, however, 63% of that (EUR 560 million) represented re-investment. Thus 44% of total income transfers were reinvested in Hungary as direct investment. Debt-creating, interest and interest-type payments increased by EUR 155 million to EUR 412 million, which is attributable to the high debt stock and the formerly emerged high Forint interest rates.

Current transfers did not improve the current account in the first quarter. In that line the position deteriorated by some EUR 100 million, which resulted from the EU-membership related contributions, which were not made in the base period. However, most EU transfers are disclosed in the capital account.

As opposed to the EUR 63 million deficit at the end of March 2004, the capital account showed a surplus of EUR 171 million. (Improvement of position: EUR 234 million).

The non-debt-generating net capital influx was EUR 218 million, almost EUR 600 million lower than in Q1 last year. Foreign direct investments continue to come to Hungary, their value amounted to EUR 881 million, EUR 183 million up on the previous year figure. On the other hand, investments of Hungarian residents abroad (MOL and Magyar Telekom) picked up, and, as a result of their expansion and the intercompany cross-subsidisation of a multinational, they rose to some EUR 500 million (by 130%) as opposed to the EUR 210 million in the base period.



The decline of portfolio investments reflected the apparently transitional trend that characterised the international stock exchange investment climate in the first quarter. The EUR 175 million disinvestments caused the position to deteriorate by 500 million as compared to the basis. In the deterioration of the non-debt-generating net capital influx position, the decline of portfolio investments played a decisive part (84%). This capital channel, which is rather volatile and subject to regional and international influences, has occasionally shown sizable fluctuations.

Annual current account deficit expected at 8.3-8.8% of GDP

In our annual forecast, the current account deficit is EUR 7.2-7.5 billion, or 8.3%-8.8% of GDP. The Q1 figures do not bring that forecast into question.

At the end of March, the portfolio of international reserves amounted to EUR 13.4 billion, EUR 1.7 billion up from end-December.

The net debt stock of the national economy amounted to EUR 20.2 billion, essentially staying level. Within that figure, the government debt increased by EUR 0.4 billion, to EUR 12.1 billion. On the other hand, the gross debt stock of the national economy increased by EUR 3.2 billion to EUR 50.4 billion[7] over the end-December figures. EUR 2.2. billion of the increment was incurred by the general government and the NBH, thus the gross debt stock of those entities increased to EUR 26.2 billion.

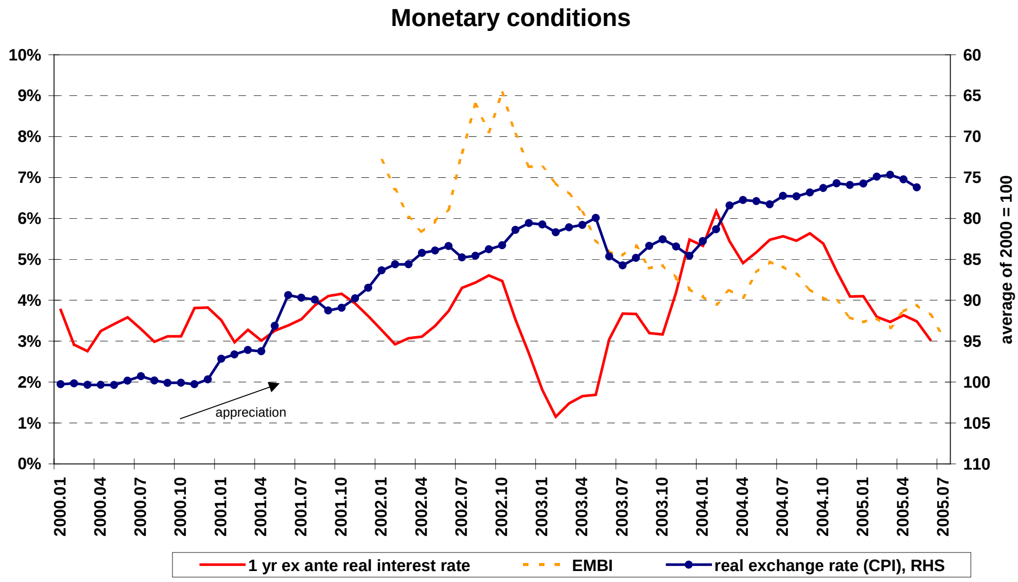
5. Monetary developments

5.1 Monetary conditions

Gradually relaxing but still tight monetary conditions

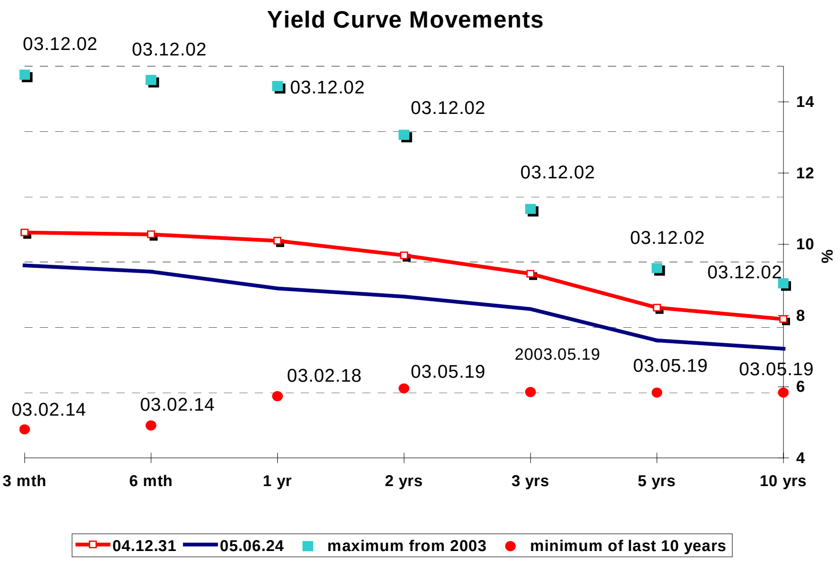
In the first half of 2005, monetary conditions were gradually relaxed on the whole, but they continued to be tight. While last year monetary policy proved to be too tight in light of the tightening fiscal and income policies, in the past months of this year monetary policy became less stringent, driven primarily by the market. On the other hand, due to the overly strong initial position, monetary conditions continue to be stringent. The appreciation of consumer price based real exchange rate continued, albeit at a gradually decelerating pace, and real interest rates declined to the previous years' levels, even though they are high by international standards.

[7] Direct investments without other equity investments (intercompany loans). According to the NBH, direct investments including other equity investments (intercompany loans): Gross debt: EUR 60.2 billion, net debt: EUR 25.7 billion



In the first half of 2005, the Monetary Council essentially followed market expectations. In each month, it reduced the base rate, essentially at the rate priced in the yield curve or indicated by surveys among analysts. The decline of long-term yields, which came to a halt in February, was resumed at the end of May, approaching the end of the inceasing cycle of US base rate.

The room for manoeuvre of the NBH was basically influanced by two factors: inflation and market. While the depreciation of the Forint in 2003 brought about major interest rate hikes, the decrease of inflation prompted only minor, though repeated, measures. The disinflation that started at end-2004 continued in early 2005: the inflation rate fell to around 3%, which can be considered as price stability in an converging economy, and the core inflation, which is especially important for monetary policy, sank to an even lower level. All these factors not only facilitated but practically compelled the interest rate cuts.



In recent years, the countries in our region have experienced strengthening real exchange rates: since 1999, real exchange rates have appreciated by 20-50%. The most conspicuous strengthening occurred in Slovakia, but in the past one and a half years Poland has topped the list, while Hungary is in the mid-range in both cases. It is important to emphasise that while in the Czech Republic and Poland the changes of real exchange rates were driven primarily by the movement of nominal rates, in Hungary and Slovakia the high inflation differential also played a major part. As by 2005 the inflation rate also fell considerably in these two countries (to around and below 3%, respectively), in the future this form of the tightening of monetary conditions and thus the deterioration of competitiveness is likely to be low in all four Visegrád countries.

The monetary conditions of our region have been influenced not only by market factors but also by the conduct of the various central banks and the application of the inflation targeting. After the introduction of the new monetary regime (inflation targeting), central banks kept exchange rates strong, and real interest rates high. When this led to the significant decline of inflation, real interest rates fell, in some instances actually turning negative. Similar trends are present in Hungary, even though the rather high real interest rates of 2004 cannot be put down exclusively to price development. Despite the significantly reduced Hungarian inflation rate in 2005, real interest rates continue to be the highest in the region: even Poland, where the indicators are very similar to those of Hungary, has considerably lower real interest rates.

5.2 Exchange rates

The exchange rate continues to be strong and stable

For approximately one year, since early July last year, the exchange rate has typically been stronger than the 250 HUF/EUR level, with the exception of May this year, when it was slightly weaker. The favourable international and regional environment also contributed to the stability of the exchange rate. The strong and stable exchange rate continued to greatly facilitate the lasting deceleration of inflation and the attainment of the inflation targets, while it has had an adverse effect on the competitiveness of the economy, which is indicated by the slow-down of economic growth and the rise of unemployment. According to the analysts' expectations, essentially unchanged for months, disclosed in the latest Reuters poll of 16 June, the exchange rate will continue to be strong (around 253-254 HUF/EUR) across the entire time horizon (up to 2006), against the background of interest rates lower than today.

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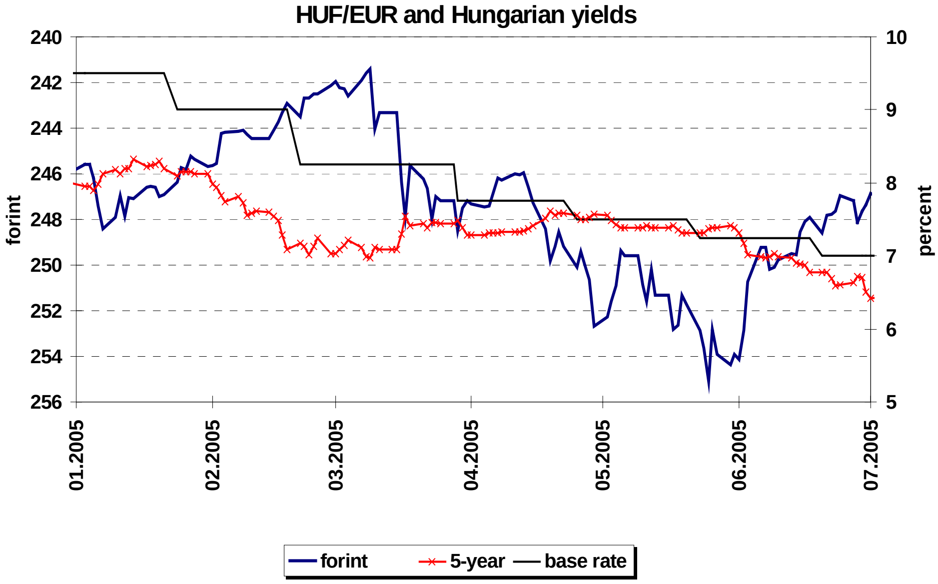
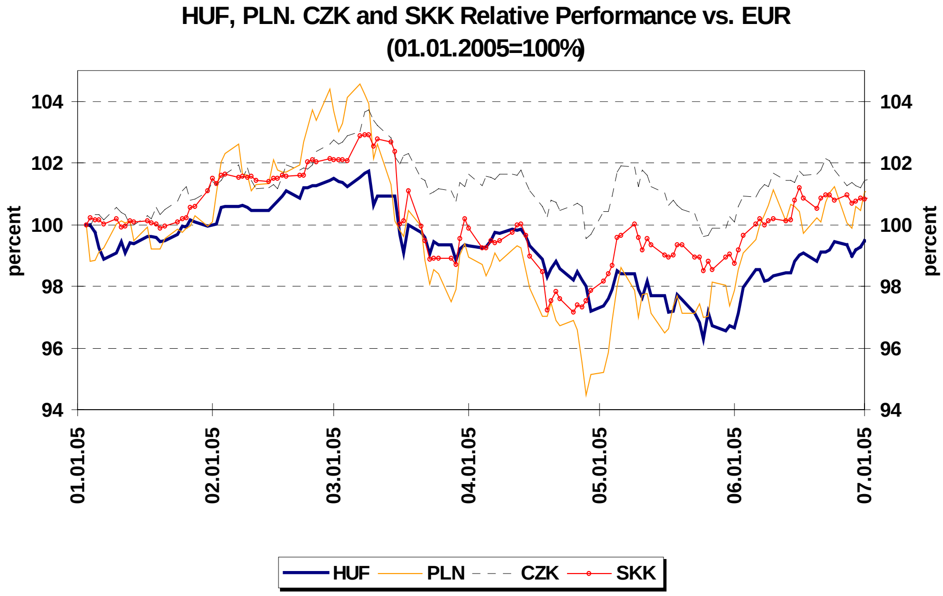


The movement of the Forint is not substantially different from the exchange rate trends of the Czech Crown, the Slovak Crown and the Zloty in 2005. The movement of these currencies is dominated by international events, the most important one being the investors' expectations concerning dollar yields' developments. Due to the growth of US yields falling short of previous expectations, these currencies have recently started appreciating again. The currencies are stable, at the end of the first half-year their exchange rate to the euro essentially standing at their level at the beginning of the year. On the other hand, the fluctuations of the euro/dollar rate were reflected in the dollar exchange rates of these currencies.

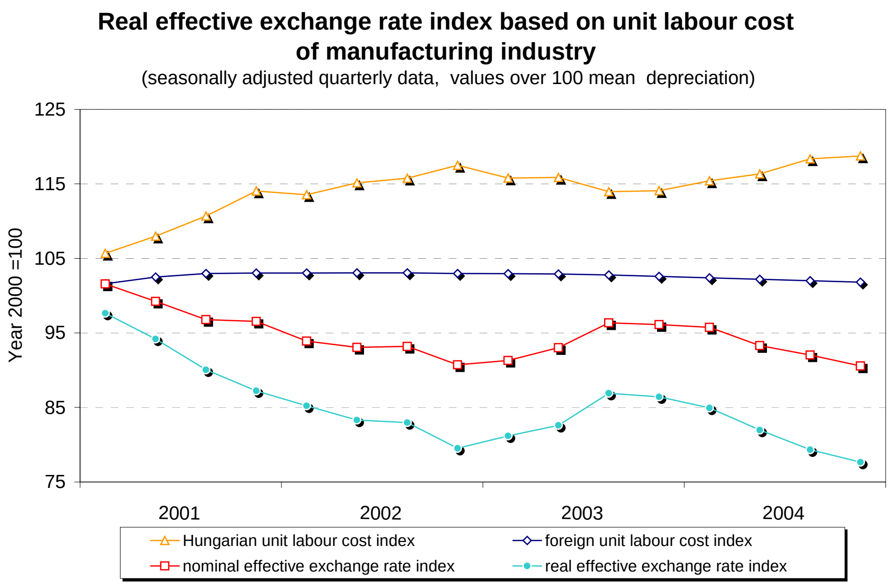
Increased correlation of the movement of the currencies of Visegrád countries



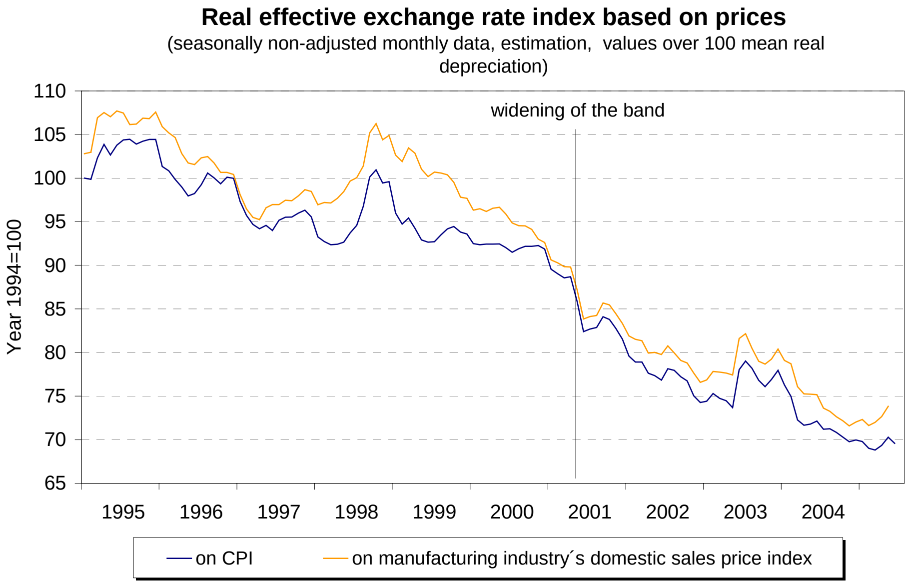
Following the drastic price and cost-based real appreciation in 2001-2002, the deterioration of competitiveness gradually slowed down in 2003, whereas in 2004 the declining trend re-appeared, to a large extent owing to the strengthening of the exchange rate. In recent years, the real appreciation was

Deteriorating competitiveness in 2004 due to strengthening driven, in addition to the nominal exchange rate trends, by wage increases being substantially faster than the moderate productivity improvement.

exchange rate



Following the approx. 6% deterioration of price based competitiveness, significant real appreciation occurred on a year-on-year basis: 5% on a CPI basis in the first half of 2005, and 5.7% on a manufacturing PPI basis as an average of the first five months. Because of the strong exchange rate, despite the significant contraction of the inflation differential to our main trading partners, the CPI-based real appreciation may be higher in 2005 again than the 1-2% level, which can be tolerated in the case of the fast-growing converging economies.

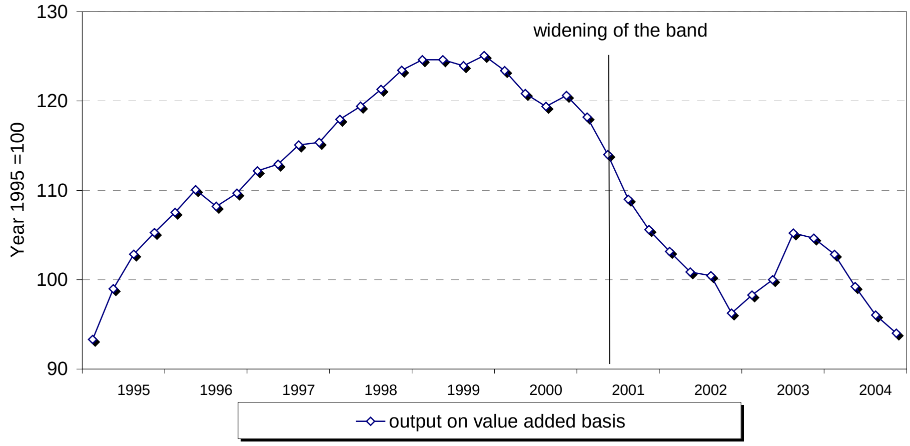


In the case of a small, open, fast-growing economy the development of cost competitiveness plays a far more important role than price competitiveness. However, no year 2005 data about cost-based competitiveness are available yet.

Last year, it deteriorated some 4% as an annual average, with temporary outstanding values underlying the adverse trend. In Q4 last year, real appreciation was at around 10% over the last quarter of 2003. However, over half of that significant decline was attributable to the fact that in Q4 of 2004 the Forint was decidedly strong, as opposed to its weakness in the last quarter of 2003. If the Forint does not become stronger in the second half of this year than in the corresponding period of last year, the cost competitiveness trend during the year will be increasingly driven by the relationship of productivity and wage outflow, and the change of the Hungarian unit labour cost as compared to the average of our main trading partners.

Real effective exchange rate index based on unit labour cost of manufacturing industry

(seasonally adjusted quarterly data, estimation, values over 100 mean real depreciation)



According to the data of Eurostat, the deterioration of Hungary's competitiveness was substantial, only Slovakia producing worse price based competitiveness trends than Hungary, while the unit labour cost based indicator was worst in Hungary.

TABLES

Table 1.

ECONOMIC INDICATORS

Real Sector, Prices, Competitivness

change from the same period of the previous year, %

	2000	2001	2002	2003	2004								2005				
	I-IV. quarter	I-IV. quarter	I-IV. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month	I. half of year	I-III. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month
GDP volume	5.2	3.8	3.5	2.9	-	-	4.5	-	-	4.5	4.3	4.2	-	-	2.9	-	-
Household consumption	4.9	6.0	9.4	7.2	-	-	1.9	-	-	2.8	3.0	2.5	-	-	2.2	-	-
Gross fixed capital formation	7.7	5.9	9.3	2.5	-	-	18.4	-	-	13.1	12.7	7.9	-	-	6.8	-	-
Exports of goods and services	22.0	8.0	3.9	7.8	-	-	19.3	-	-	19.3	16.4	14.9	-	-	6.2	-	-
Imports of goods and services	20.3	5.3	6.5	11.0	-	-	13.5	-	-	15.8	13.6	11.6	-	-	4.8	-	-
Volume of retail trade turnover 11/	2.0	5.4	10.7	8.4	5.7	5.0	5.2	6.6	6.6	7.4	6.4	5.6	2.3	1.8	3.1	2.5	2.9
Volume index of investments	7.4	3.5	7.8	2.2	-	-	18.9	-	-	13.5	13.2	7.8	-	-	6.8	-	-
Foreign trade turnover: export volume	21.7	7.8	6.8	9.1	19.9	20.6	20.1	18.4	18.2	20.4	18.0	16.9	9.4	8.1	7.7	9.9	9.8
import volume	20.8	4.0	6.1	10.1	12.0	13.7	16.1	18.2	16.9	18.2	15.8	13.8	10.7	7.6	4.5	2.7	2.8
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Volume of industrial production	18.1	3.6	2.8	6.4	7.6	9.6	10.4	10.1	9.5	10.4	8.9	8.3	3.4	1.9	1.7	3.6	5.4
Volume of construction-installation activities	7.5	8.3	17.8	2.0	20.3	17.7	15.3	12.8	8.4	7.4	6.5	6.8	9.4	16.8	11.7	14.4	-
Number of employees (in thousands)																	
household survey (annual average)	3,829.1	3868,3*	3,870.6	3,921.9	3,884.1	3,887.1	3,891.5	3,889.1	3,788.9	3,892.8	3,897.4	3,900.4	3,864.3	3,864.3	3,870.6	3,772.3	3777.3
labour statistics 2/	2,718.1	2,720.8	2,726.1	2,752.8	2,763.3	2,764.7	2,768.6	2,774.2	2,779.6	2,784.2	2,791.5	2,789.6	2,773.9	2,773.2	2,772.9	2,775.8	-
Vacancies (in thousands) 3/	39.2	37.3	34.0	44.0	38.2	51.3	56.3	59.3	58.1	54.9	46.9	30.7	34.1	34.7	40.5	45.4	-
Number of unemployed (in thousands) 3/	372.0	342.8	344.9	359.9	388.0	401.7	396.9	378.4	361.6	350.7	364.9	400.6	430.3	433.3	436.3	419.4	-
Rate of unemployment (household survey, %)	6.4	5.7	5.8	5.9	6.3	6.2	6.1	6.1	6.0	6.0	6.0	6.1	7.2	7.1	7.1	7.2	7.2
Consumer price index	9.8	9.2	5.3	4.7	6.6	6.9	6.8	6.8	7.0	7.1	7.0	6.8	4.1	3.6	3.6	3.7	3.6
Index of industrial domestic sale prices	14.5	9.4	1.6	5.0	7.3	7.2	7.2	7.5	8.0	8.2	8.5	8.4	10.6	10.3	10.2	10.2	-
Index of industrial export sale prices	8.6	1.5	-4.5	0.3	3.9	3.1	2.1	1.9	1.8	1.3	0.2	-0.4	-1.3	-1.6	-0.7	-0.1	-
Agricultural production prices	22.5	4.9	-1.1	5.3	14.4	14.9	14.5	13.5	15.5	14.7	3.4	-5.4	-13.3	-13.8	-12.9	-11.9	-
Competitiveness 10/																	
based on CPI	-5.4	-7.7	-9.1	-1.4	2.5	1.0	-0.4	-1.3	-1.5	-2.6	-4.7	-5.8	-8.5	-8.2	-7.1	-6.1	-5.4
based on manufacturing prices	-1.8	-9.0	-7.8	-0.9	2.9	2.0	0.6	-0.3	-0.8	-2.0	-4.5	-5.7	-8.6	-8.8	-7.7	-6.7	-
based on ULC (value added)	-2.8	-7.8	-10.3	1.8	-	-	4.6	-	-	1.9	-1.8	-3.9	-	-	-	-	-

Table 2.

ECONOMIC INDICATORS

Income and Monetary Aggregates

change from the same period of the previous year, %

		2000.	2001	2002	2003	2004								2005				
		I-IV. quarter	I-IV. quarter	I-IV. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month	I. half of year	I-III. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month
Average earnings:	gross 1/	13.5	18.0	18.3	12.0	7.2	8.0	9.2	9.0	8.5	8.5	7.9	8.2	6.9	6.7	6.7	6.7	-
	net 1/	11.4	16.2	19.6	14.3	6.4	7.0	8.0	7.8	7.4	7.5	7.0	7.1	8.9	8.8	8.7	8.6	-
Household	savings (HUF billion)	1,032.3	1,146.9	1,220.1	1,184.3	-	-	229.2	-	-	590.0	845.0	1,401.5	-	-	379.2	-	-
	credits (HUF billion)	240.6	379.3	778.2	1,163.3	-	-	201.5	-	-	467.6	719.3	1,041.3	-	-	86.8	-	-
General government GFS balance (HUF billion) 4/		-480.2	-444.0	-1,685.6	-1,094.5	-218.8	-341.3	-434.7	-547.5	-722.4	-1,040.2	-1,284.2	-1,285.1	-198.4	-393.9	-484.9	-710.0	-837.7
Central budget	GFS balance (HUF billion) 4/	-368.7	-402.9	-1,469.6	-732.4	-173.9	-246.7	-364.9	-426.9	-508.8	-855.5	-1,035.8	-890.0	-199.1	-379.0	-373.1	-589.0	-680.5
	primary balance (HUF billion)	329.7	212.7	-832.0	-4.1	-141.5	-108.7	-186.3	-141.2	-169.8	-398.0	-412.8	-87.5	-167.7	-217.4	-189.9	-288.5	-338.4
	revenue change 4/	14.2	10.5	7.1	13.3	-11.7	5.5	8.1	7.3	5.8	5.6	4.9	8.2	26.7	19.6	22.3	10.6	11.1
	expenditure change 4/	13.7	10.4	30.4	-2.7	20.7	16.4	17.3	17.0	16.9	19.4	15.4	9,9	23.2	27.6	17.6	16.2	15.7
Social Security Funds 5/: balance		-81.4	-28.8	-100.9	-349	-59.0	-115.3	-91.3	-146.4	-236.2	-208.2	-284.5	-422,9	-9.8	-38.4	-136.9	-153.9	-186.0
	revenue change	10.7	18.6	17.2	4.5	4.3	4.1	8.5	8.8	8.5	9.5	10.1	7.7	24.4	2.0	11.1	15.9	17.7
	expenditure change	12.5	14.9	20.4	14.2	10.1	9.0	9.2	7.2	11.9	11.1	10.2	9.6	2.1	6.6	15.6	14.4	10.7
Government paper benchmark yields (average annual) 6/																		
	3 month	11.80	9.80	8.20	11.99	12.21	12.58	12.10	11.58	11.35	11.46	10.96	9.11	8.84	8.23	7.34	7.37	7.32
	12 month	11.60	9.21	7.95	11.68	11.85	12.49	11.20	10.68	10.67	11.07	10.78	8.67	8.5	7.5	7.21	7.36	7.35
	3 year-bonds	10.70	8.17	7.37	10.17	10.29	11.17	10.36	9.71	10.12	10.60	10.40	8.49	8.11	7.93	7.16	7.52	7.41
	5 year-bonds	9.11	7.72	7.01	9.28	9.22	9.92	9.34	9.14	9.46	9.36	9.51	7.86	8.19	7.18	7.44	7.18	7.19
	10 year-bonds	9.04	7.06	6.45	8.03	8.12	8.76	8.22	8.19	8.44	8.46	8.58	7.06	7.39	6.62	7.12	6.82	6.98
	15 year-bonds	0.00	6.68	-	-	-	8.21	-	7.44	8.44	-	8.25	-	6.8	-	6.73	6.87	-
Interest rates 6, 7/:																		
with maturity less than a year	credit	12.8	11.2	9.7	13.39	13.53	13.56	13.54	13.40	12.80	13.30	12.94	10.99	10.37	9.94	9.33	8.99	8.6
	deposit	9.5	8.4	7.4	10.96	11.06	11.07	11.22	11.20	10.60	10.60	10.34	9.09	8.55	8.01	7.37	6.95	6.5
with maturity more than a year	credit	13.4	11.2	9.7	13.04	13.84	13.88	13.49	13.40	13.40	12.20	12.88	11.22	10.45	10.95	10.44	10.33	10.8
	deposit	9.4	7.7	8.0	10.80	9.10	7.40	8.00	10.80	10.30	10.70	10.04	8.25	7.53	6.98	5.23	6.70	5.2
Increase of money supply 8/		12.9	17.2	18.9	10.1	15.7	8.4	5.5	10.7	11.7	16.1	10.1	9.8	11.1	20.0	27.8	24.3	17.2
Current account of balance of payments (mEUR)		-4,352	-3,577	-4,929	-6,364	-302	-790	-1,308	-2,341	-	-3,561	-5,411	-7,118	-	-	-1,497	-	-
Without reinvested earnings		-3,281	-2,049	-3,046	-4,649	-121	-427	-842	-1,930	-	-3,599	-4,538	-5,249	-	-	-943	-	-
Net foreign debt denominated in foreign currencies (bEUR) 9/		7.4	4.5	5.5	8.0	.	.	8.6	.	.	9.8	9.9	10.9	-	-	-11.2	-	-
BUX index 3/		7,865	7,122	7,739	9,627	10,064	10,242	10,992	11,072	11,285	11,537	12,647	14,743	15,553	18,383	17,108	16,378	16,908

METHODOLOGICAL REMARKS

for Table 1 and 2

Signs: * Preliminary data; **.** : data is not available yet; **-** : no data for the period

1/ In public sector the data for december of 2004 and for the year 2005 are corrected with the regulation-change of the additional one month salary, MoF estimate;

2/ Data for firms with more than 5 employees and for budgetary institutions total.

3/ End of period data.

4/ Excluding privatization receipts and contributions paid into the compulsory funded pension funds. At the general government the interim data do not include the local governments.

5/ Total revenues and expenditures of the Pension Fund and Health Fund are not consolidated with the non-self-provided services.

6/ The yield or interest in the last month of the period.

7/ At deposits with maturity longer than a month but not longer than a year.

8/ M3 does not include deposits with an agreed maturity over 2 years and debt securities with over 2 years' agreed maturity issued by motetary financial institutions. However, it includes holdings by residents other than monetary financial institutions of MNB bonds with up to 2 years' agreed maturity plus holdings by residents other than monetary financial institutions of investment units issued by money market funds.

9/ Excluding intercompany loans

10/ Price based indicators seasonally non-adjusted, unit labour cost based indicators seasonally adjusted

11/Including sales of motor vehicles and antomative fuel